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Bank-firm Cross-shareholding in Japan: What is it, why does it matter, is it winding down?

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Abstract

An institutional structure of corporate groups evolved over the post-war years in Japan, wherein members of a group were linked together through mutual shareholding, often with commercial banks at the centre of the network. This paper examines the functioning of cross-shareholding, as it involved Japan's commercial banks in the 1990s. It finds that the banks have not been especially successful "monitors" of members of the corporate groups and that corporate management had relatively negative appraisals of the banks. Japan has been passing through a major financial crisis, which has shaken up the role of banks within its main bank system. It has also reduced the extent of cross-shareholding of banks. However, cross-shareholding continues to provide implicit relational contracts that play a role in Japanese business society. This study highlights the importance of paying adequate attention to historical and institutional factors in analyses of development.

Key words: Banking, Japan, corporate governance, cross-shareholding

JEL classification code: G32; L2.

Introduction

It has been a common practice in Japan for pairs of firms to exchange equity shares in each other, a practice called "cross-shareholding." Sometimes the firms have been in the same industrial group, sometimes they are suppliers and customers, and sometimes creditors and borrowers. This paper focuses on the problems relating to bank-firm cross-held shares.

The shares cross-held by banks and firms became a matter of grave concern in the 1990s in part because most Japanese banks depended on the market value of stocks held in their portfolios to help satisfy capital adequacy standards. With the huge decline in the Tokyo stock market during the 1990s, at times falling to less than one-third of its 1989 high level, banks had great difficulty in maintaining the level of capital required to meet the Basel Committee standards to operate internationally, let alone to cover the burgeoning amounts of bad debt. Moreover, the greatest part of bank-held shares have been in each bank's client firms and thus the fortunes of banks and firms were lashed together, as Japan faced its most profound economic crisis of the post-war era.

By the middle 1990s, it appeared that the prevalence of bank-firm cross-shareholding might be winding down, although it was not yet clear in the data. However, the major mergers and closure of large banks as the decade ended could signal the start of a new era. Whether or not winding down, it appears that bank-firm cross-shareholding has been a factor in the protracted financial crisis of the second largest economy in the world. This in itself would warrant investigation of the phenomenon; but such a study may be of interest as well for the light it sheds on relations that can develop between banks and their client firms, albeit in a specific institutional context.

Much of bank-firm cross-shareholding in Japan has taken place within groups of interrelated firms, typically with a large bank at the centre, the "main bank". The implications of cross-shareholding and related issues in regard to the role of the main bank have been extensively studied and debated in the context of the governance of modern Japanese firms and questions of "industrial organization" [Scher, 1997, 1998; Ito, 1993; Nomura Sogo Kenkyujo, 1992; and Okumura, 1990]. Some economists suggest that the groups helped to manage risk in the Japanese economy [Nakatani, 1984; Aoki, 1984]. A number of Japanese studies have asked if there was a positive effect of cross-shareholding upon stock prices [Ikeo, 1993; Kanesaki, 1986; Kawakita, 1992, 1993; Kobayashi, 1991, 1992; Kumagai, 1994; Kurasawa, 1984; Ogishima, 1993; Wakasugi, 1982]. Other analysts, including this author, have been critical of bank-firm cross-shareholding. Two studies by Japanese research teams have analyzed corporate attitudes towards cross-shareholding in the 1990s, based on surveys of management, focusing in particular on the firms' relationship with their main bank [Omura, 1993; and Fuji Sogo Kenkyujo, 1993]. They found corporate management to be generally critical of bank-firm cross-shareholding relationships.

This study draws upon these previous works, as well as on interviews undertaken by the author with the management of Japanese banks. It embodies an extension of the information collected in multiple in-depth interviews with seventy-seven Japanese bank practitioners,[1] so as to now cover the period from 1992 to 1999, a very turbulent period for the Japanese financial sector.

The development of cross shareholding

Kabushiki mochiai (mutual aid shareholding) is the Japanese term for what is customarily translated as "cross-shareholding", that is, equity shares that two companies hold in one another. Cross-shareholding, in turn, is a subset of what is known as *antei kabunushi* (quiescent stable shareholding), which may be held in trilateral, multilateral, or otherwise stable arrangements among companies, usually based on group and/or transactional relationships. Together, the various forms of stable shareholdings comprise some 65 per cent to 70 per cent of all stock issued by publicly traded corporations in

1 For a detailed description of the interview methodology, see Scher 1997, 1998.

Japan. The remaining shares are freely traded on the stock exchanges.

Cross-shareholding in Japan, however, represents much more than a single-dimension ownership relationship. It often also reflects other understood but unstated obligations. As will be noted, cross-shareholding arrangements in the post-war era operated as tacit mutual pacts designed to insulate the management of both sides from any market threat of hostile takeover. The purpose of most cross-shareholding is to avoid rather than confer shareholder rights, so stable shareholding relationships function as a strategy of corporate management to limit shareholder governance of the firm.

Cross-shareholding may be divided into two categories: (1) cross-shareholding between members of a horizontal corporate conglomerate group, or *kigyo shudan*, the core of stable shareholding arrangements, and (2) cross-shareholding that reflects business relationships between suppliers and customers. In neither case is the cross-shareholding relationship intended to confer the ownership rights inherent in the Anglo-American model of corporate governance. Cross-shareholding arrangements between suppliers and customers are primarily a franchise to do business, a method of cementing transactional relationships. It is within this category of transactional relationships that one should view the shares of stock that a bank and its major client firms cross hold.

The same is true for insurance companies and trust banks (which are financial institutions that invest funds placed with them "in trust", such as custodial accounts). They typically own shares in companies with which they do a significant amount of business, including selling insurance and pension fund products to the client firm and its employees. Such transaction-related shareholdings are considered to be separate and apart from any holdings of the client firm's stock that these financial institutions may have in their investment portfolios.[2]

Pros and cons of cross-shareholding

In 1992, Japan's Economic Planning Agency (JEPA) responded to criticism raised by the Government of the United States in the Strategic Structural Initiative (SSI) trade negotiations that cross-shareholding promoted unfair trading practices and that Japan's cross-shareholding and main bank system specifically locked out foreign-owned banks. In its reply, JEPA advanced three main economic justifications, among others, for cross-shareholding, characterizing them as "merits."

First, it argued that cross-shareholding provides a stable source of funding for businesses by ensuring that there will be partners who will be stable investors and who will buy new issues of stock whenever needed. Second, according to JEPA, cross-shareholding strengthens the stability of corporate management by acting as a bulwark against the threat of hostile takeover. Such arrangements relieve management of the necessity of responding to excessive pressures from the capital markets, permitting it to develop operations according to a long-term perspective. Lastly, JEPA maintained, cross-shareholding stabilizes and strengthens business transactions between companies. The JEPA White Paper of 1992 termed cross-shareholding a mutual "hostage" taking, which creates a captive relationship in the supply of goods or services and promotes long-term transactional relationships between cross-shareholding companies.

However, JEPA accepted the point that group companies tend to do business mainly with each other, thus making it difficult for foreign investors to break into Japanese networks, and thus that extensive cross-shareholding among members of a corporate group could lead to exclusionary, anti-competitive business practices:

> "Even though interlocking stockholding has the functions mentioned above, if it creates a relationship of 'conspiracy', business may

2 In the author's interviews, trust bank and insurance executives reported that they principally rely on fixed-income securities in their investment portfolios to meet their actuarial needs, and that the overwhelming percentage of client firm equities being held were for "relational" purposes (see Scher, 1997 and 1998, as well, for a discussion of the types of transactional business relationships that financial institutions have with their client firms and their employees).

become inefficient. What is more important, in selecting the customers, if it is taken into account whether or not they have interlocking stockholding unrelated to their individual products or substance of service, or cartel relations come into existence between competitors, competition may be limited" [Japan Economic Planning Agency, 1992, p.181].

In addition, scholars in Japan have long criticized the practice of cross-shareholding as limiting shareholder governance, which they have characterized as among its major "demerits", particularly in terms of management accountability. In other words, without effective oversight by shareholders of corporate operations and managerial performance, Japanese managers had little incentive to seek to maximize profits [Ito, 1993]. This is typically contrasted with the United States, where shareholders, at least theoretically, oversee the effectiveness of corporate management, and where the possibility exists of shareholders exercising their rights to change management if operations become too inefficient. Corporate management in the United States is thus given the incentive to focus on the more effective operation of the company for the benefit of the shareholders. In Japan, however, the mutual non-interference agreements generally implied in a Japanese cross-shareholding relationship gave Japanese corporate management an abundance of discretion in making business decisions and in regulating itself. This allowed inefficiencies to build up that produced a low return on equity. Indeed, declaring shareholder dividends has been neither a necessity nor even a priority concern of Japanese corporate managers [Nomura Sogo Kenkyujo, 1992].[3]

Another significant demerit raised by critics in Japan is the potential for cross-shareholding agreements to damage and even defraud shareholders. Cross-shareholding represents an offsetting exchange of stock between companies, in most cases entailing no injection of new outside capital. Normally, when a company issues ¥100 million in stock, the company uses the funds to acquire productive assets worth ¥100 million. However, in a cross-shareholding arrangement, when a company issues stock to a partner, there are usually no net proceeds, just the receipt of new stock in exchange; such a transaction is purely a paper one. Third-party investors in both firms might be made worse off in that their ownership share in the equity of the firm has been diluted by the increase in the number of shares without there being a corresponding increase in the earning capacity of the shares from investment [Okumura, 1990]. In addition, there has been an unspoken fear among third-party shareholders that any large-scale sell-off of shares into the market by a cross-shareholding partner (i.e., without either consultation or the replacement of that partner with another stable shareholder) could cause the collapse of the company's share price in the equity market.

The widespread practice of cross-shareholding has also been criticized as having negative effects on the stock market. As cross-held shares in a company are rarely traded on the exchange, the effective market in each company's stock is restricted to a fraction of the firm's outstanding shares. Thus, according to this view, speculators can manipulate the market price more easily. Such speculation by Japanese investors would tend to discourage outside investors, and, in overall terms, would dissuade participation of longer-term investors.

However, other analysts have taken the contrary view. Under the efficient-markets hypothesis of the Modigliani-Miller Theorem, stock prices are based upon the fundamentals of companies, in particular, their net asset values. Cross-shareholding should not affect a company's value, and therefore cross-shareholding should not affect stock prices [Ikeo, 1993]. Still other analysts believe cross shareholding has a positive effect on price/earnings ratios [Ogishima, 1993], and some 82 per cent of company executives surveyed held the belief that cross-shareholding had a beneficial effect in stabilizing their own company's stock price [Omura, 1993].

Whether positive or negative on a net basis, the

3 This might be changing in that stable shareholders did count on income from their shares in the form of capital gains and the 1990s were a major disappointment on that score. A majority of publicly held firms thus expected increased demand for dividends from their stable shareholders.

standard practice of enterprises holding substantial shares in other enterprises, owing primarily to the cross-shareholding phenomenon, creates an interdependency in the prices of enterprise shares. The shares of companies holding stock in other companies are more vulnerable to share price volatility the larger the holdings of such stock. The interdependency arises because when a firm has large holdings of shares in other companies, its own profits can depend to a significant degree on the price performance of those shares. If stock prices go up, the company earns “hidden profits” from those stocks; but if the prices of those stocks go down, they will have unrealized losses. As the market is at least implicitly aware of these unrealized gains and losses, it affects the first firm’s own stock price. Indeed, Japanese companies that showed a steady rise in their core business income between 1985 and 1991, suffered unrealized losses on shares held in other companies when the stock market declined from 1989 to 1991. This resulted in a decline in their own company’s stock price during those years, despite the core business profits, the effect being greater the greater the extent that they engaged in cross-shareholding [Kawakita, 1992].

Evolution of cross-shareholding in the postwar period

The post-war cross-shareholding arrangements grew out of the dissolution of the *zaibatsu* in the initial period of the Allied occupation of Japan following World War II. The *zaibatsu* were holding companies, each of which held shares in and controlled a group of firms, many of which, in turn, had controlling interests in other firms (albeit often through a minority stake). The dissolution was intended to introduce “Western” principles of corporate democracy and to dismantle the industrial underpinnings of Japanese militarism. The divestiture by the *zaibatsu* of their corporate holdings under the Anti-Monopoly Act of 1949 led to an increase in stock ownership by individual investors. As a result, individual investors held 69 per cent of all outstanding shares in 1949, a level that would fall dramatically as cross shareholding was resurrected (see figure 1).

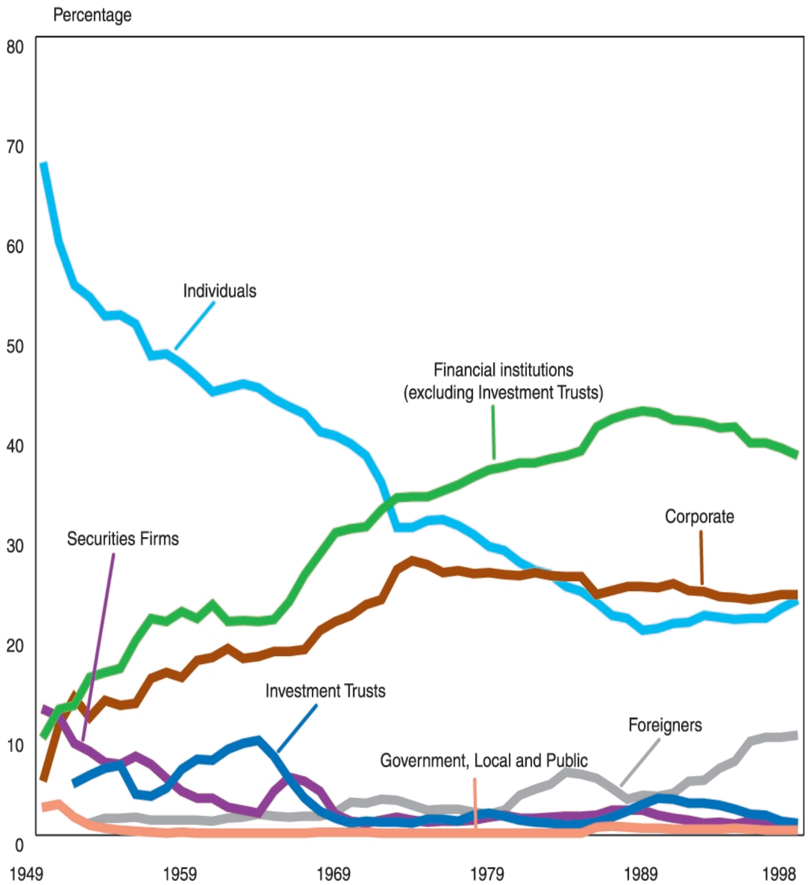
The cross-shareholding system as it existed by the 1990s was the result of three stages of major buildup: the first in the early 1950s, the second from the middle 1960s to early 1970s, and the third in the late 1980s. The corporate equity market in the early 1950s was characterized by active takeovers and free-wheeling shareholder meetings. During this period, speculators purchased stocks, which management bought back at a higher price (greenmail). Companies wanted to protect themselves by cross-shareholding. However, the provisions of the Anti-Monopoly Act prohibited stockholding by companies. Revision of the Act in 1953 allowed companies to invest in stocks of other companies, providing their stock holdings could not be construed as anti-competitive. The resurrection of cross-shareholding during this period was thus primarily intended to protect companies from unsolicited acquisition by speculators, who were particularly active after Japanese stock prices collapsed following the end of Japan’s economic boom during the Korean War. The 1953 easing of the Anti-Monopoly Act also raised the upper limit of shareholdings by financial institutions from 5 to 10 per cent.

This first stage in the development of cross-shareholding was also significant in that the former *zaibatsu* groups of Sumitomo, Mitsui, and Mitsubishi re-established themselves as a new form of grouping of companies, called *kigyo shudan*, with their trading companies and banks at the centre of their groups (see below).

The second stage in the growth of cross shareholding was precipitated by the collapse of share prices in 1964-65 and the first Yamaichi Crisis (1964), in which Japan’s fourth largest securities company was faced with imminent bankruptcy. In order to boost the Japanese stock market, a special corporation, the Nihon Kyodo Shoken (Japan Cooperative Securities Co.), was set up by the securities industry with Ministry of Finance (MoF) administrative guidance to make major purchases of shares. Another factor was Japan’s having become a member of the Organization for Economic Cooperation and Development in 1964. As a condition of membership, Japanese capital markets were to be gradually deregulated, causing the MoF as well as business to become concerned about preventing hostile takeovers by foreign investors.

Once the Yamaichi bankruptcy had been

Figure 1.
Distribution of share ownership in Japan, 1949-1998



Source: Zenkoku Shoken Torihikijo Kyogikai.
Note: Data pertain to all listed companies on Tokyo Stock Exchange, fiscal-year basis, following Japanese convention (e.g., "1949" means 31 March 1950).

averted, the Nihon Kyodo Shoken was able to sell the shares it had accumulated. It proceeded to sell the shares to group-linked companies and their banks. As these shares were unlikely to be sold, it reduced the threat of hostile takeovers by either domestic or foreign investors. In addition, Section 280 of the Commercial Act was revised so that boards of companies would be able to allocate newly issued shares to specified companies and individuals. Such allocations were made primarily to financial institutions and companies within their own group, resulting in further stabilization and concentration of stock ownership. This strengthened the aforementioned successors to the prewar *zaibatsu* groups and aided newly emerging *kigyo shudan*, centred around Sanwa, Dai-Ichi Kangyo Bank (DKB) and Fuji Bank.[4]

The second stage of the growth of cross-shareholding ended with the introduction of a new policy to curtail the practice. After the first "oil shock" hit Japan in the fall of 1973, inflation rose and the price increases were seen as having been engineered by the corporations. This led, after much opposition, to adoption of the 1977 Anti-Monopoly Reform Bill, which entailed a reduction by the Fair Trade Commission of the allowed bank shareholding of company stocks from 10 to 5 per cent. The implementation of this reform, however, was stretched over ten years.

The third stage in the growth of cross shareholding accompanied the "bubble period" of the late 1980s, when corporations took advantage of high and rising equity prices and flooded the stock market with new issues as a way to raise funds. By itself, this would have increased the proportion of company shares that were actively traded, relative to the "quiescent stable shares". However, the issuance of new cross-held shares could prevent this, which was thus the primary purpose for the issuance of such shares in this period.

This was also a period of intensive *zaitech* ("financial engineering") investment in securities by corporations, unrelated to investment for cross-

4 Although Fuji Bank's so-called Fuyo group originated before the war as the Yasuda group of financial companies, it was not a fully developed *zaibatsu*, since during the prewar period it lacked a manufacturing base. Member companies of the Kawasaki and the Furukawa groups, both smaller former *zaibatsu*, now belong to the DKB group, thus leaving Sanwa, the only bank purportedly without any *zaibatsu* past, with the sobriquet "The People's Bank." More recently, however, Sanwa has been tracing its roots to the Konoike finance house of the early seventeenth century.

shareholding purposes. That is, many companies sought to bolster their profits from gains in the rising stock market. The portfolio of the *zaitech* investor, like any unaffiliated investor, was strictly speculative, in anticipation of capital gains, and generally took the form of *tokkin* accounts, that is, discretionary trusts managed by their brokers. Firms following this practice thus built up their portfolios of shares in other firms and if after several years these new shares were not traded, they would appear quite like traditional "stable" shares. Indeed, after the stock market crashed there was little incentive to sell these shares.

In fact, when analysts observed a reduction in corporate shareholding portfolios in the late 1990s, they measured the fastest rate of dissolution as being in the stable-shareholding category. However, it is difficult to distinguish sales of shares that had actually been part of a firm's stable shareholding from sales of *zaitech* shares which it would have been timely to sell given that the Tokyo market had regained some strength as foreign buying increased substantially in the mid-1990s.[5] In any event, by this time the period of strong growth in cross-shareholding had ended.

Corporate groups, main banks and cross shareholding

As a result of the preceding developments, several *kigyo shudan*, or corporate enterprise groups, developed into huge conglomerates during the post-war period. Among the largest were those affiliated with the top six "city" banks, although a distinction should be drawn between the Mitsui, Mitsubishi, and Sumitomo groups, which were the direct descendants of the pre-war *zaibatsu* of the same names, and the groups that were affiliated with Dai-Ichi Kangyo, Sanwa, and Fuji Banks. As can be seen in table 1, the pre-war *zaibatsu* groups of Sumitomo and Mitsubishi have had a higher percentage of cross-shareholding than the bank-centred groups of

Table 1.
Cross-shareholding ownership of firms in corporate (Kigyo) groups: total and amount held within group, 1987-1997

	Mitsubishi		Sumitomo		Mitsui		Fuji		Dai-Ichi Kangyo		Sanwa			
		WG		WG		WG		WG		WG		WG	Total[a]	Total[b]
1987	27.4	16.5	31.5	13.5	28.3	11.2	31.4	12.4	28.4	9.3	25.8	10.1	31.1	18.6
1988	27.3	16.7	32.7	14.2	28.8	12.0	30.3	11.5	28.6	8.7	25.4	9.6	31.3	19.7
1989	28.7	17.0	32.8	14.5	28.7	11.9	29.8	11.6	27.4	8.6	24.8	9.2	31.1	19.8
1990	29.8	17.7	33.6	14.9	30.0	11.3	30.3	11.8	28.2	8.7	25.9	9.4	31.9	20.4
1991	30.5	17.8	34.3	15.3	29.0	10.3	30.9	12.2	28.9	8.7	25.7	9.5	32.0	20.2
1992	31.2	18.3	34.8	15.1	31.1	11.5	31.2	12.2	28.5	8.4	26.4	9.7	32.8	20.2
1993	31.1	17.9	33.3	14.8	31.2	11.2	30.5	12.0	28.1	8.4	26.5	9.7	32.4	19.5
1994	30.8	18.1	33.1	14.6	31.3	11.2	30.2	11.8	28.6	8.4	25.8	9.4	32.5	19.8
1995	30.1	17.8	31.9	14.3	29.8	11.0	29.7	11.5	27.8	8.3	25.3	9.2	31.4	18.7
1996	30.8	16.8	30.9	14.9	31.6	10.9	26.4	10.3	26.5	8.0	24.0	8.7	31.0	17.9
1997	29.8	16.7	30.9	15.0	32.0	10.8	24.6	9.2	26.3	8.3	2.4	8.8	30.7	16.4

Source: NLI Research Institute (1999).
Note: Following Japanese convention, data are for end of fiscal year (e.g., "1987" should be understood as 31 March 1988).
a Kigyo groups.
b Non-Kigyo groups.
WG: Within group.

5 A study by NLI Research Institute [1998] of 2,426 firms saw stable holding of their shares fall from over 41 per cent at the end of fiscal 1992 to under 36 per cent in fiscal 1997. During the same period, foreign holdings of the shares in these firms more than doubled, from 6.3 per cent to 13.4 per cent.

Fuji, Dai-Ichi Kangyo (DKB), and Sanwa (the Mitsui group has had weaker cross-shareholding ties as a result of circumstances following its postwar dissolution).

Members of the former *zaibatsu* groups consider their trading company or the original core company within their group as the group's centre, although the group's bank also plays a significant role. Group identity and loyalties are thought to be far stronger among the more tradition-bound former *zaibatsu* groups than they are in the post-war bank-centred DKB, Sanwa, and Fuji *kigyo shudan*. Within all of the *kigyo shudan*, however, the group's bank and other financial institutions, together with the group's trading company, have the most ties with all of the other group members by virtue of the basic nature of their transactional business.

In addition to the six largest *kigyo shudan*, other significant groups arose, for example, around such banks as the Industrial Bank of Japan (IBJ), the largest of the long-term credit banks, or the Tokai Bank, based in the Nagoya region. There have also been many other groups of lesser size associated with smaller city banks that have a strong regional base, or with the regional banks themselves or the second-tier regional (formerly *sogo* or mutual) banks, all of which had their "groups". Cross-shareholding has been an important attribute of these groups as well.

In each of these cases, it appears that the objective of the cross shareholding, in particular as it pertained to the main bank, was strategic rather than for investment income. Evidence from interviewed bankers [Scher, 1997; 1998] indicates that it has long been a very common practice for banks and other cross-shareholders, when share prices have risen, to sell and then immediately repurchase their cross-held shares in order to realize the capital gains. While this captured profits that helped to dress up their annual statements, it left intact their ratio of cross-held to total shares. That banks felt obliged to repurchase these shares suggests that the purpose of this shareholding was to retain close transactional ties to client firms. This is no different from the expectation of firm executives for stable long-term transactional ties with their non-financial cross-shareholding partners. The obligations of bank-firm relationships are similar to the close vendor/supplier relations that non-financial companies also must maintain with their cross-shareholding business partners. As one banker reported to the author, his bank's sale of any client shares required the assessment of the bank's relationship to the firm and approval by three departments before the client shares might be sold.[6]

Main banks within the groups: historical roots

Of all of the cross-held share relationships within the *kigyo shudan*, one of the most significant has been a firm's relationship with its main bank. The "main bank relationship", as it came to be called, is said by some to have had its origins in the 1930s, when Japan's economic planners sought to insure that companies deemed essential to the military economy received adequate funding for the production of munitions. Asajima [1984], studying *zaibatsu* group financing of the late 1930s, noted the Sumitomo group's shift of financing functions from its holding company to the group's bank and trust company. Teranishi [1994] pointed out the parallels between the role of the lead bank in a risk-diversification strategy for wartime loan syndication and in the postwar credit crunch period, while T. Okazaki [1994] emphasized the significance of the wartime planned economy and the National Mobilization Act. Another argument put forward is that the system was the unfortunate result of the timing of the 60-year renewal of the Bank of Japan's charter in 1942, which consciously imitated that of the 1939 Reichsbank [Noguchi, 1995]. In any event, by 1944, as Horiuchi [1989] points out, when the MoF ordered the 700 largest companies to specify their "main banks," the Government was merely making explicit previously established *de facto* lead bank relationships.

6 When shares are sold to raise cash, the first to be sold are likely to be *zaitech* shares, those shares which were purchased by corporations as speculative investments during the *zaitech* era (the period of financial "engineering") in the late 1980s. The rationalization of speculative investments from the *zaitech* era is to be expected, whereas shares that were acquired as part of a cross-shareholding pattern based upon customer-supplier relationships had a different purpose.

Others, however, see the main bank system as a reaction to the unusually free-wheeling financial markets of the post-World War I decade (1919-1929). This *laissez-faire* period was characterized by economic chaos and bank failures that ultimately led to the MoF's intervention in the 1927 bank crisis. Indeed, one can go back further in history and say that the policy-based finance system has its oldest roots in the oligarchic rule of the Meiji *genro*, the "elder statesmen" period of the late nineteenth century, especially in the initiatives of Meiji Finance Minister Masayoshi Matsukata, who was noted for excluding parliamentary authority and the involvement of democratic processes, as he constructed a policy for economic development, including adoption of the German central-bank model.[7] Seen in this light, the *laissez-faire* period in the 1920s was an aberation.

In fact, it is not useful to attempt to pinpoint the passage of any one government act or section of the Commercial Code as the foundation of modern-day bank-firm relationships in Japan. Such relationships not only predate the modern period, but extend back in time to the exchange houses, the money lending stores, and the lending practices to group member houses of the *Ômotokata* (central business offices) of the great merchant households of the Tokugawa period.

A comparative institutional analysis that has also been popular in some circles is misleading as well. This is to compare the cross shareholding between the Japanese firm and its main bank to the German *Hausbank* system [see, for example, Carrington and G. Edwards, 1979]. There is a genre of literature, paralleling the literature on the Japanese main bank system, which favourably compares the *Hausbank's* attributes to the market-based financing of the Anglo-American finance model and extols the purported efficiencies of German bank-based financing and bank monitoring [see for example: Cable, 1985; Crafts, 1992]. In this view, the *Hausbank* is not only a shareholder. It also exercises governance in the German two-tier board system by virtue of its dominant membership on the client firm's supervisory board of directors, which it achieves through control of a substantial number of proxies. However, recent scholarship provides evidence that the outcome of such governance claims has been largely overstated [Baums, 1994; J. Edwards and Fischer, 1994]. Despite their position on the supervisory board, banks do not appear to play an active governance role [Wenger and Kaserer, 1998].

This much has also been the case for Japanese banks, albeit for a different reason. Though shareholders, Japanese main banks are seldom in a position to influence policy, even in those firms in which they hold outside directorships. Typically, the Japanese firm's board of directors is made up almost entirely of inside directors, that is, the firm's own executives, who are beholden to the president and chairman, both of whom retain real power along with the board's executive committee, also composed of inside directors.

The main bank relationship

The post-war relationship of the main bank with other firms in its group has been seen as largely beneficial to the firms and society. The reasons have generally been classified as falling in the following three areas: (1) efficiency of capital derived from delegating the function of monitoring to the main bank as the implicit agent of the other creditors (and by extension of shareholders in the firm as well), which was called the "signal function"; (2) main bank assistance to firms in financial distress, the so-called "rescue function"; and (3) the main bank role in corporate governance. From the time these arguments emerged, however, their credibility was questioned by scholars in Japan studying the main bank system. In particular, they questioned the existence of such benefits, the efficacy of the relationship, and the actual role of the group's main bank in risk-sharing, and at least one scholar has even questioned the existence of the main bank itself [Miwa, 1985, 1991].

Much of the theorizing on the positive role of

7 As Yoshino [1977] points out, contrary to the apocryphal stories regarding Japan's adoption of the Belgian model for its central bank, the Ministry of Finance in 1882, under the direction of Count Matsukata, after a rigorous process of examining the charters of more than thirty foreign central banks, decided upon the German model because it provided for the greatest control by the Ministry over the financial system, to the exclusion of parliamentary intervention.

the main bank relationship originated in a number of articles written by Nakatani on the purported governance/monitoring effects of the main bank within the industrial group. Nakatani put forward the notion that the industrial groups performed a risk-sharing function for their members, especially those grouped around a bank, which he saw as the group's centre, and that the chief mechanism of that risk-sharing was the main bank's implicit assumption of the role of risk-insurer for the group's member firms [1983, 1984]. Nakatani also contended that the ongoing main bank relationship, an implicit long-term contract, provided a continuous signal of the creditworthiness of the client firm to banks and financial institutions outside the group. Nakatani's overall approach emphasized the stabilizing effect of the main bank on the long-term performance of the firm. From this starting point, a number of hypotheses have been proposed by economists, principally focusing on the efficiency of capital in the main bank relationship and its benefits to the firm.

In Sheard's [1989, 1994a, 1994b, 1994c] expansion on Nakatani's thesis, he argues that the main banks are relatively efficient at gathering information about their clients and therefore are able to effect more efficient solutions to the "asymmetric information" problem. This view derives much of its theoretical foundation from Diamond's 1984 discussion of information asymmetries and the costs of delegated monitoring, where he asserts that monitoring delegated to a bank as a financial intermediary allows better contracts and a Pareto-superior allocation of resources. Sheard [1989, 1994c], in his application of Diamond, relies heavily on anecdotal material from the business press in Japan, citing news stories of the main bank's rescue role in times of financial distress for his evidence. For additional support, he points to the dispatch of bank employees on temporary assignments to the client firm and the role of the main bank in negotiating with other creditors for more lenient terms for the client firm.

Some economists [Sheard, 1989, 1991; Aoki 1990] have stressed the main bank's monitoring role, particularly in light of its shareholding in its client firms, suggesting that the relationship represents a form of corporate governance in which the bank acts as the delegated monitor for the group's cross-shareholding member firms. Other shareholders are then able to "free ride" on the main bank's alleged monitoring activities. Aoki [1994] parses monitoring into three conceptual stages: *ex ante*, the evaluation of potential new projects of the client firm; *interim*, the ongoing monitoring of the performance of the firm; and *ex post*, the exercise of control over firms in financial distress. [8]

What the Aoki model does not consider, however, is that for many years, inter-bank competitiveness has been subverting the monitoring process.[9] That is, most large firms deal with a number of banks, with which they have bigger or smaller relations and which compete with each other for the firm's business. Non-main banks have only been too eager to lend to a client for *ex ante* projects, thereby gaining a foothold with which to increase their position in the lending hierarchy, if not displace the main bank. *Interim* monitoring, chiefly done by the bank team, turns out to be related more to the sales function of the team as it competes with the teams of other banks. Again, this is not an exclusive role of the main bank, but rather one method used by the bank as it vies against a whole hierarchy of rival banks.

Finally, when a main bank learns that any of its firms are financially troubled, "*ex post* monitoring by the bank" may actually entail taking advantage of the opportunity of insider information (to the extent it has any) to hasten its own strategic retreat. If possible, the bank cuts back its loan exposure in advance of the other banks within the lending hierarchy [Scher, 1997; 1998; 1999]. Moreover, the so-called "rescue" for most firms arranged under what is called *ex post* monitoring is often the seizure of its collateral and an acquisition by a firm favoured by the main bank. The main bank is thereby placed in a conflict of interest, not only *vis-à-vis* its fellow shareholders, but its fellow creditors as well.

8 See also Hoshi [1990a, 1990b, 1991].
9 Other criticisms can be found in articles by Horiuchi [1989], Horiuchi and Fukuda. [1987], Horiuchi *et al.*[1988], Oba and Horiuchi [1991], and R. Okazaki and Horiuchi [1992].

Furthermore, this potential conflict is readily apparent to the other members of the cross-shareholding group, who will have observed that the bank's interests as a creditor (to recover its loans) are not necessarily aligned with its interests as an investor (to protect its equity stake, when it is still positive). When those two interests clash, the significance of the bank's role as shareholder will yield to its overriding concern as creditor.

In other words, the monitoring role places the main bank in position to make first claims upon a firm's assets, to the detriment of the other principals (i.e. shareholders), or even the firm's other creditors. As chief reorganizer and receiver of the firm in any reorganization plan, the main bank would be able to structure the workout to its own advantage, whether it is through dissolution of the firm, the seizing of collateral, or the continued infusion of cash and a negotiated easing of terms for new credits from the firm's other banks. Only when the bank discerned that one of its client firms was in the midst of a liquidity crisis rather than insolvency would it have the incentive to attempt an actual "rescue" [author's interviews].

By the second half of the 1990s, after a string of experiences, the main bank rescue function was largely demythologized, although the belief in the function still persists in much of the academic literature.[10] Nevertheless, a belief remained among some practitioners that the function had existed in the past. In my 1997 interviews with Japanese bankers, who for the most part began their careers in the 1970s or 1960s, some acknowledged the belief that main bank rescues had occurred, but that "it was before their time." My most senior respondent, a former director and an *OB* ("Old Boy") of a major bank who had begun his career in 1943 with the Yokohama Specie Bank, (forerunner of the Bank of Tokyo), replied that he too thought that the rescue function had existed but that it was "before his time". It was not until the collapse of the bubble economy in the late 1980s that the rescue function was seriously tested, and it failed. It may therefore be concluded that the main bank rescue function existed only in some mythical Golden Age in antiquity.

Perceptions of bank-firm relationships

The view of the main bank relationship presented here, at least as it pertains to the 1990s, is also supported by my research data and the data of the Fuji Research and Omura studies [Fuji Sogo Kenkyujo, 1993; Omura, 1993]. These last two studies, which reported on perceptions of the main bank from the perspective of the client firm, revealed that corporate executives generally saw the main bank relationship as lacking the benefits it purportedly accords the firm. This view was shared by banker practitioners in my data [Scher 1997; 1998], who also dismissed ideas of such benefits to the firm. Yet both the Fuji and the Omura data and my own qualitative data from banker practitioners clearly show that the main-bank relationship itself existed, was stable, and was part and parcel of expectations coming from traditional ideas of relationships. Furthermore, although the benefits of the relationship may have been perceived as doubtful by the client, the bankers believed the relationship was quite profitable for the bank.

The two surveys that studied corporate executives' perceptions of their main banks demonstrate that non-financial company managers did not regard mutual stock ownership as financial investments, but rather as mutual security and non-aggression pacts. Indeed, the corporate managers themselves (as agents in their own firms) made non-interference pacts with their counterparts in the other firms so as to protect their own incumbency. In contrast to the attitude of managers who are keen to promote the interests of shareholders as investors, the majority of publicly traded firms in the Fuji survey would only concede that it was "somewhat necessary" to disclose information to individual investors. They saw their annual financial statement as sufficiently informative. Of the privately held firms, almost 72 per cent saw no necessity for disclosure whatsoever, beyond what was reported in their annual statement. Few companies saw any need to explain their policies for distribution of profits, management of capital expenditures or future project plans [Fuji Sogo Kenkyujo, 1993].

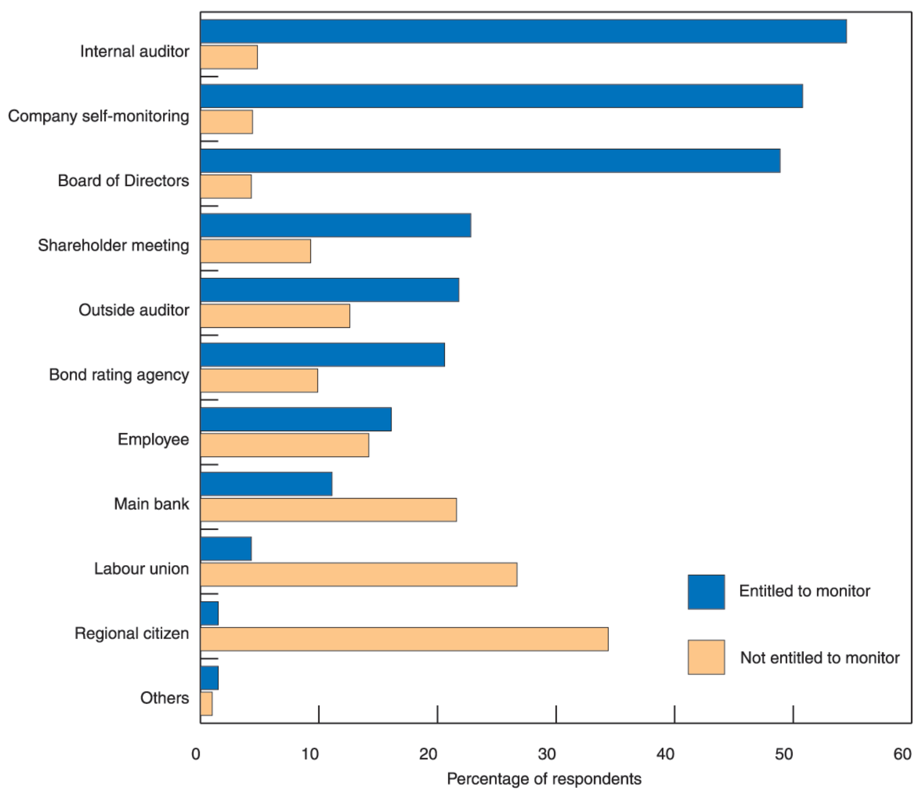
10 Some of the original authors of the Nakatani-Aoki-Sheard-Hoshi thesis have sought to limit the applicability of the thesis to the time up to the high-growth period of the mid-1970s (see Aoki, Patrick, and Sheard [1994]).

By the same token, it is not surprising that the firms in both the Fuji Sogo Kenkyujo and Omura surveys reported that they had a distinct preference for *not* selecting a bank as one of their stable shareholders. Moreover, according to Fuji Sogo Kenkyujo data, firms did not believe that their own banks had a right to monitor them (see figure 2). Among the list of stakeholders, almost 22 per cent of the executives surveyed felt that the main bank was not entitled to monitor, compared with only 11 per cent who thought the main bank was entitled. Indeed, this rejection of the main bank's purported agency role was even more evident among the responding firms listed in the First Section of the Tokyo Stock Exchange. There, only 4 per cent of the executives felt that the main bank was entitled to monitor, whereas almost 25 per cent felt the main bank was not so entitled.

Privately held firms viewed their fellow non-financial "group" members as their most reliable shareholders. The stable shareholders most preferred by listed firms (and second most preferred by privately held firms) were companies that were not their banks or other financial institutions or even from their own group, thus enabling them to avoid the web of transaction expectations and obligations that often come with these types of institutional partners. Some 406 out of 570 privately held firms in the Fuji Sogo Kenkyujo [1993] survey reported that they had no stable shareholding relations with banks, compared with only 101 of the 604 publicly traded respondents.

For the non-financial firms which did have cross-shareholding relations with banks, 64 per cent of these firms expressed concern about the falling share prices of the bank stocks they held (as did 78 per cent of those firms which were having their own share price difficulties) [Omura, 1993]. Holding these bank shares was seen by firms as a burden rather than a benefit. Many of those bank shares were bought during the late 1980s when client firms were importuned by their banks to purchase their shares — or lent funds by the bank to make

Figure 2.
Firms report who is entitled to monitor their activities



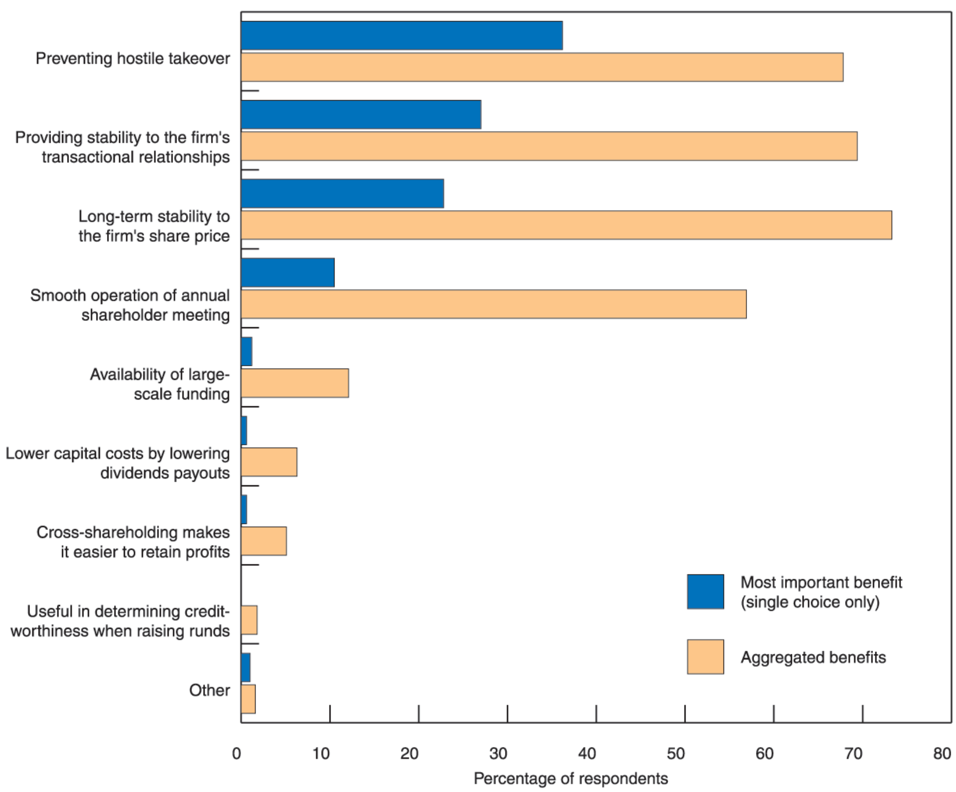
Source: Translated by the author from survey data of Fuji Sogo Kenkyujo [1993].

the purchase — as banks sought to raise capital to meet Basel Committee capital-adequacy requirements.

The Omura data [1993] further revealed that the only firms which valued their cross-shareholding relationships with financial institutions more than with non-financial shareholding partners were those firms that were highly dependent upon banks, not a surprising result. This category of firm was characterized as having relatively small capital, low efficiency of capital (low ratio of pretax income to total capital), low capital/assets ratio, low growth of capital, large decline in stock price, and low concentration of ownership. Another key factor reported by Omura as raising firm dependency on banks was the overall poor health of the particular industry to which the firm belonged. This included publicly traded companies in such ailing industries as iron and steel and, to a lesser degree, machine tools, electrical machinery, trading firms, and the services industries. The respondent companies from the healthy (at the time of the survey) high cross-shareholding automotive industry saw cross-shareholding relations with financial institutions as much less beneficial than those with their own suppliers or vendors.

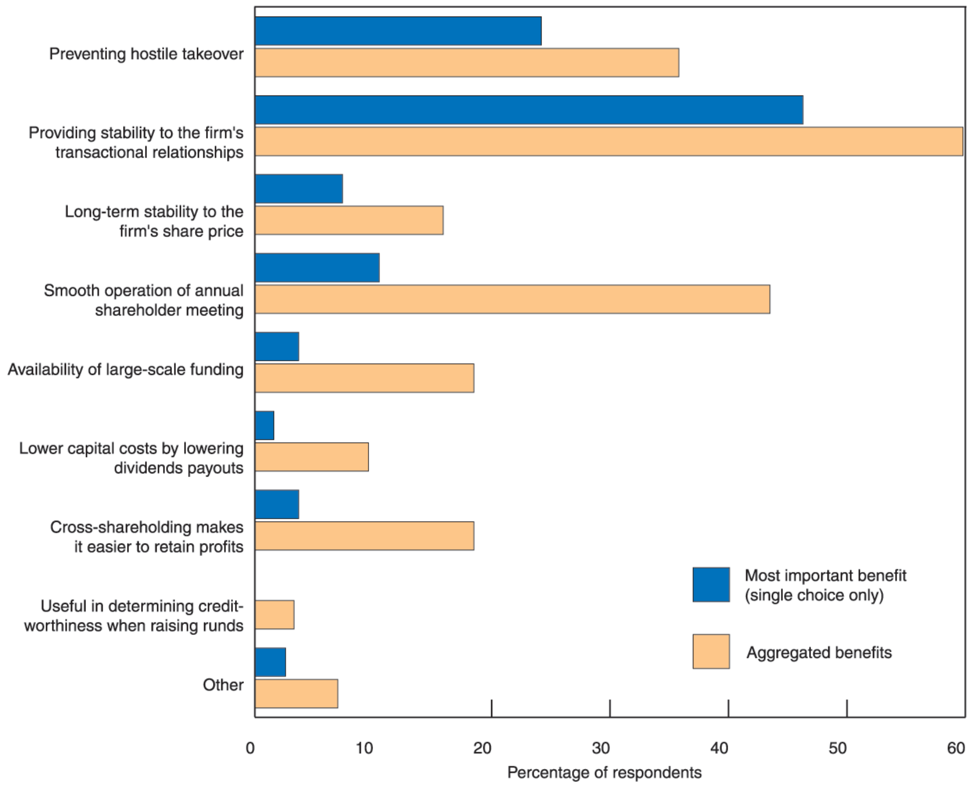
Executives of publicly traded firms reported in the Fuji survey that the single most important benefit of cross-shareholding was that it prevents hostile takeover (36 per cent) (see figure 3). Second in importance was the "stability" cross-shareholding provided to the firm's transactional relationships (27 per cent), and third, to the firm's share price (23 per cent). The smooth operation of annual shareholder meetings (over 10 per cent) was cited fourth. Executives at privately-held firms reported their main benefits from cross-shareholding as providing stability to transactional relationships (46 per cent) followed by the prevention of hostile takeovers (24 per cent); smooth operation of annual shareholder meetings ranked third (over 10 per cent) (see figure 4).

Figure 3.
Benefits ascribed by publicly-traded firms to cross-shareholding



Source: Translated by the author from survey data of Fuji Sogo Kenkyujo [1993].

Figure 4.
Benefits ascribed by privately-traded firms to cross-shareholding



Source: Translated by the author from survey data of Fuji Sogo Kenkyujo [1993].

Recent developments

In the light of the views expressed by managers in non-financial firms, one might expect to observe a significant reduction in bank-firm cross-shareholding. In fact, data compiled by NLI Research Institute of Tokyo show this to have been the case, mainly owing to changes at the end of the 1990s. In a sample of 2,426 firms, about a fifth of corporate and bank equity had been owned by cross-shareholding firms in the late 1980s and much of the 1990s (see table 2). The ratio last exceeded 21 per cent in fiscal 1992. By 1998, the ratio had fallen to 16 per cent. As may be seen in the table, although there were some declines across the board, the largest ones were in firm holdings of bank stocks (bank holdings of other banks' stocks virtually disappeared). Table 3 shows the decline in firm holdings of bank stocks in more detail, albeit for a shorter period. The greatest sell-off has been of failed or failing banks (sales of shares in Bank of Tokyo-Mitsubishi by client firms reflect reduced shareholdings after their merger).

Banks have also reduced their rate of cross-shareholding. For example, table 4 shows reductions in the rate of cross-shareholding in their clients by most of the large banks, i.e., except for Tokai Bank and Asahi Bank, two banks that had announced merger plans, but that also had strong regional franchises in the Nagoya area and Saitama Prefecture. Furthermore, table 5 shows that fifteen regional banks increased their cross-shareholding between fiscal 1992 and 1997. In the light of the financial distress of the large banks, this data suggest that banks reduce their cross-held shares when they have to and otherwise would maintain their transactional ties with their client base through cross-shareholdings.

Perhaps this is the conclusion to be drawn as well from the differential sales of cross-held shares by banks and their client firms, as shown in table 6. It appears that banks do not rush to sell these shares when the firms sell

Table 2.
Bank-firm cross-shareholdings, 1987-1998 [a]
(Percentage)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Firm holds firm shares	4.1	4.4	4.7	4.8	4.9	4.7	4.7	4.8	4.9	5.0	4.7	4.3
Firm holds bank shares	6.7	6.0	5.5	5.9	5.7	6.0	5.8	5.7	5.4	4.2	3.5	3.2
Bank holds firm shares	6.2	6.7	6.8	7.2	7.3	7.2	7.0	7.1	7.0	7.7	7.5	6.5
Bank holds bank shares	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.3	0.2	0.1	0.0
Other entities	4.0	3.6	3.01	3.1	3.1	2.9	2.9	2.9	2.8	2.5	2.3	2.0
Total	21.5	21.0	20.3	21.4	21.3	21.2	20.8	20.7	20.3	19.5	18.2	16.0

Source: NLI Research Institute (1999), based on sample of 2,426 firms.
Note: As per Japanese convention, data are as of end of fiscal year (i.e., "1987" means as of 31 March 1988).
a Percentage of firm and bank equity mutually held by other firms and banks.

Table 3.
Bank stocks held by firms, 1989-1996
(Percentage of stock of each bank held by firms)

	1989	Annual percentage change							1996
		1990	1991	1992	1993	1994	1995	1996	
Industrial Bank of Japan	43.2	-0.4	2.5	-0.1	-1.1	-0.1	-1.3	-2.2	40.5
Long Term Credit Bank	43.5	1.5	0.4	-0.9	-0.4	0.8	-0.5	-3.3	41.1
Nippon Credit Bank	21.7	-0.2	3.4	0.4	-2.0	1.3	-0.4	-4.6	19.6
Dai-Ichi Kangyo Bank	46.0	0.3	-0.1	-1.0	-0.5	-0.2	-1.1	-0.8	42.6
Sakura Bank	44.7	-4.0	0.0	-0.6	0.2	0.6	-1.3	-1.6	38.0
Fuji Bank	53.1	1.2	-0.7	-0.1	-0.8	-0.2	-1.3	-3.4	47.8
Bank of Tokyo Mitsubishi	39.1	0.9	1.0	0.1	-0.3	0.1	-0.3	-4.3	36.3
Asahi Bank	34.1	0.6	-1.2	-0.7	0.5	0.6	0.2	0.5	34.6
Sanwa Bank	41.2	2.4	-2.0	-0.2	-0.3	-0.1	-0.6	0.0	40.4
Sumitomo Bank	48.3	1.5	-1.8	0.0	-1.0	-1.7	-0.4	0.5	45.4
Tokai Bank	35.0	1.2	-0.3	-0.6	0.0	-0.3	1.5	0.3	36.8
Hokkaido Takushoku Bank	26.7	1.3	-0.5	-0.1	-1.0	0.1	-0.9	-2.6	23.0

Source: Tamiya, 1997.
Note: Data on a fiscal year basis (e.g., data for 1990 show percentage change from 31 March 1990 to 31 March 1991).

their corresponding shares in the banks, or at least that sell-offs by clients do not necessarily cause the bank to reciprocate. In particular, the table shows that while trading companies such as Itochu and Marubeni have been net sellers, the only bank that made a more or less consistent effort to reduce its holdings of client shares at a rate equal to that of its cross-shareholding partners was the Industrial Bank of Japan.

When banks do sell shares, it has been predominantly shares of other banks, securities houses and insurance firms (see table 7). It is also usually the case that the banks selling these shares are not the main bank of the firms and that the firms had already sold their shares in the banks. The firms whose shares the

Table 4.
Cross-shareholding by major banks, 1992 and 1997

	Percentage[a]		Number of cross-shareholding corporations	
	1992	1997	1992	1997
Industrial Bank of Japan	45.0	38.9	464	442
Long Term Credit Bank	44.4	36.6	308	284
Nippon Credit Bank	25.2	13.6	152	138
Dai-Ichi Kangyo Bank	44.8	42.6	558	534
Sakura Bank	39.7	31.9	760	669
Fuji Bank	53.0	47.6	572	555
Tokyo-Mitsubishi Bank	40.8	34.6	514	639
Asahi Bank	32.1	32.5	395	380
Sanwa Bank	41.1	37.2	560	545
Sumitomo Bank	47.7	44.9	408	417
Tokai Bank	35.0	35.1	449	406
Yokohama Bank	18.0	17.1	181	175
Other regional banks	—	—	1041	1101

Source: "Kabushiki mochiai no jokyo", Nissei kiso kenkyujo, 1998.
a Percentage of bank's holding of corporate shares that are cross-held.

Table 5.
Cross-shareholding by regional banks, 1992 and 1997
(Percentage)

	1992	1997
Fukuoka Chuo Bank	0.0	7.4
Kyoto Bank	17.2	23.5
Minami Nippon Bank	0.0	5.7
Miyazaki Taiyo Bank	0.0	5.4
Kinki Bank	2.9	7.9
Kumamoto Family Bank	0.1	3.9
Sensu Bank	1.6	4.9
Ikeda Bank	5.7	8.7
Mie Bank	6.4	8.9
Nishi Nippon Bank	11.2	13.6
Fukuoka City Bank	7.0	9.2
Chukyo Bank	5.8	7.8
Kyushu Bank	0.3	2.1
Kansai Bank	2.8	4.6
Musashino Bank	1.5	3.1

Source: NLI Research Institute, 1998.

banks have been selling were generally firms belonging to the much-troubled construction, real estate, securities and financial service industries. These industries were the front-line casualties in the collapsed bubble economy.

Overall, the highest degree of cross-shareholding has occurred among institutions within the financial sector, such as regional banks, mutual banks, finance companies, casualty insurers, leasing companies and other financial service companies. Fifteen out of the top sixteen companies in which city, regional and long-term credit banks held shares were in fact other financial institutions [Zenkoku Shoken Torihikijo Kyogikai, 1992]. It has thus been the failures, mergers and reorganizations within the financial services industry itself which have been most responsible for the realignment of cross-shareholding.

Bank mergers themselves cause sales of cross-held shares by the merged bank. If each of two banks that merge held shares in a client firm, then the new merged bank should sell off enough of those shares to

Table 6.
Selected firms that reduced shares held in banks in 1997: net reduction in holdings in major banks and net reduction of bank holdings in the firms
(Hundred million yen)

		Asahi	Sakura	Sanwa	Sumitomo	DKB	Tokai	IBJ	NCB	LTCB	Fuji	Hokkaido Takushoku	Total
Itochu Co.	BSFS	0	59	0	23	0	0	0	0	0	2	0	84
	FSBS	15	26	23	19	0	0	8	0	2	40	0	133
Hitacho	BSFS	0	0	14	0	0	0	13	0	0	0	0	28
	FSBS	0	0	50	0	31	0	29	0	0	46	0	156
Mitsui Co.	BSFS	0	0	0	0	0	0	14	0	0	0	0	14
	FSBS	0	0	0	0	0	4	16	0	0	47	0	67
Mazda	BSFS	0	0	0	0	0	0	0	0	2	0	0	2
	FSBS	2	4	3	35	0	0	13	3	4	0	0	63
Toppan Printing	BSFS	0	0	0	0	0	0	0	0	43	0	0	43
	FSBS	0	0	0	0	0	0	6	0	13	0	0	19
Nissan Motors	BSFS	0	0	0	0	0	0	43	0	0	0	0	43
	FSBS	0	0	0	0	0	0	13	0	0	0	0	13
Kanematsu	BSFS	0	7	0	0	0	3	0	5	0	0	0	16
	FSBS	0	6	0	0	8	7	2	4	0	0	1	28
Sanyo Electric	BSFS	0	0	0	16	0	0	0	0	16	0	0	32
	FSBS	0	0	0	9	0	0	0	2	0	0	0	11
Ishihara Sangyo	BSFS	0	0	0	0	0	4	0	0	0	0	0	4
	FSBS	0	14	0	0	0	7	0	0	13	0	0	33
Marubeni	BSFS	0	0	0	0	0	0	2	0	0	0	0	2
	FSBS	25	0	0	0	0	0	0	8	0	0	0	33
Teisei Kensetsu	BSFS	0	0	0	0	0	0	0	17	0	0	0	17
	FSBS	0	7	0	0	0	0	0	6	3	1	0	18
Daido Tokushunko	BSFS	0	0	0	0	0	0	5	0	0	0	0	5
	FSBS	0	0	0	0	0	7	21	0	0	0	0	28
Toyo Kensetsu	BSFS	0	0	1	0	0	0	0	0	0	0	0	1
	FSBS	0	0	27	0	0	0	0	0	0	0	0	27
Kubota	BSFS	0	0	0	0	0	0	12	0	0	0	0	12
	FSBS	0	0	0	0	0	0	10	0	0	0	0	10
Asahi Glass	BSFS	0	0	0	0	0	0	0	0	5	0	0	5
	FSBS	0	0	0	0	0	0	0	0	0	11	0	11
Shinagawa Shirorenga	BSFS	0	0	0	0	0	0	2	0	0	0	0	2
	FSBS	0	0	0	0	0	0	13	0	0	0	0	13
Kitz	BSFS	0	0	0	0	1	0	0	0	0	0	0	1
	FSBS	0	0	0	0	12	0	0	0	0	0	0	12
Showa Aluminium	BSFS	0	0	0	0	0	0	0	0	0	8	0	8
	FSBS	0	0	0	0	0	0	0	0	0	4	0	4
Shionogi Pharmaceutical	BSFS	0	0	0	0	0	0	0	0	0	0	6	6
	FSBS	0	0	0	0	0	0	0	0	0	0	5	5
Ube Kosan	BSFS	0	0	0	0	0	0	0	0	2	0	0	2
	FSBS	0	0	5	0	0	0	3	0	0	0	0	8

Source: Tamiya, 1997.
Note: The Bank of Tokyo Mitsubishi is not included owing to the effects of the merger.
BSFS: Bank selling firm shares; **FSBS:** Firm selling bank shares.

Table 7.
Top 5 stocks sold by each bank, 1997

Industrial Bank of Japan	Dai-Ichi Kangyo Bank	Fuji Bank	Tokao Bank
1. Nomura Securities	1. Yamaichi Securities	1. Nikko Securities	1. Denso
2. Tokyo Electricity and Power	2. Hino Motors	2. Tonen	2. Ishihara Sangyo
3. Daiwa Securities	3. Xcel	3. Hino Motors	3. Nippon Gaishi
4. Nintendo	4. Ohkura Co.	4. Showa Denko	4. Kanematsu
5. Japan Steel	5. THK	5. Kankaku Securities	5. Osaka Seitetsu

Long-Term Credit Bank	Hokkaido Takushoku Bank	Sumitomo Bank	Asahi Bank
1. Nomura Securities	1. Shionogi Seiyaku	1. Sumitomo Trust and Bank	1. Industrial Bank of Japan
2. Daiwa Securities	2. Mitsui Kensetsu	2. Itochu Co.	2. Hino Motors
3. Nikko Securities	3. Kyokuyo	3. Sanyo Electricity	3. Nippon Credit Bank
4. Toppan Printing	4. Nittetsu Semiconductor	4. Asahi Beer	4. Tokai Bank
5. Kawasaki Steel	5. Tada Kensetsu	5. Nippon Credit Bank	5. Homark

Nippon Credit Bank	Sakura Bank	Sanwa Bank
1. Sanwa Bank	1. Nintendo	1. Industrial Bank of Japan
2. Daitokyo Marine Ins. Co.	2. Industrial Bank of Japan	2. Hitachi
3. Mitsui Fudosan	3. Itochu Co.	3. Nippon Credit Bank
4. Taisei Kensetsu	4. Tokyo Sowa Bank	4. Denso
5. Sumitomo Co.	5. Kao	5. Ihara Chemical

Source: Toyo keizai shinposha's "Dai-kabunushi Data", as cited in Tamiya, 1997.

bring the new bank's total holdings down to 5 per cent of the firm's equity. Since the main bank is typically the greatest cross-shareholder among the banks that are part of the firm's stable shareholders, a merged bank that was not the main bank of the firm would have been compelled by custom to reduce its shareholding even further. In other words, a 5 per cent shareholding is generally an indication that the bank is the main bank of that firm, while lesser percentages of cross-held shares, for example, 4 per cent or 3 per cent or less, would indicate that these banks were second or third banks in the firm's lending hierarchy.

In fact, merged banks were able to circumvent the imperative to sell down cross-held shares, as they had when the 5 per cent maximum shareholding rule was introduced with passage of the 1977 Anti-Monopoly Reform Bill, as mentioned earlier. In addition, in the bubble period of the late 1980s, when banks were supposed to be lessening their cross-held share ratios to meet the 5 per cent maximum share-holding requirements, bankers shifted excess shares to bank-owned subsidiaries [author's interviews]. In particular, in the Bank of Tokyo-Mitsubishi case, the excess shareholdings were transferred to bank-owned subsidiaries. However, in the most recent cases—including the merger of IBJ, Dai-Ichi Kangyo and Fuji Bank, as well as Asahi Bank and Tokai Bank, and Sakura Bank with Sumitomo Bank — the pressure on the banks to sell cross-held stocks has been lessened by a new Bank Holding Company Law, which allows the new bank entities up to 15 per cent shareholding in client firms.

Of course, banks as a group were buying shares as well as selling them. We thus find evidence that some banks were increasing their holdings of the shares of a number of client firms (see table 8). In fact, banks continued to acquire shares in firms that had newly become main bank clients. Asahi Bank and Tokai Bank (both with strong regional bases) and most recently firms in the Fuji group and in Sakura Bank's Mitsui group have also increased their holdings in order to strengthen their group's main bank.

Table 8.
Selected firms that increased shares held in banks in 1997: net increase in holdings in major banks and net increase in bank holdings in the firms
(Hundred million yen)

		Asahi	Sakura	Sanwa	Sumitomo	DKB	Tokai	IBJ	NCB	LTCB	Fuji	Hokkaido Takushoku	Total
West Japan Railway	BBFS	0	131	131	131	131	0	131	0	0	131	0	787
	FBBS	0	27	0	0	0	0	0	0	0	0	0	27
Japan Tobacco	BBFS	0	0	0	0	34	0	47	0	0	41	0	122
Industries	FBBS	0	0	11	6	22	0	16	0	0	28	11	94
Honda Motors.	BBFS	37	0	37	0	0	37	13	0	0	0	0	124
	FBBS	4	0	4	0	0	5	0	0	0	0	0	13
Matsuzakaya	BBFS	5	0	0	0	0	0	0	0	0	0	0	5
	FBBS	4	0	0	0	0	101	0	0	0	0	0	105
Sharp	BBFS	0	0	3	0	0	0	0	0	0	4	0	7
	FBBS	0	0	27	0	7	0	0	0	0	29	0	63
Tsubaki Nakashima	BBFS	9	8	2	0	0	14	0	0	0	0	0	33
	FBBS	7	0	2	0	0	13	0	0	0	0	6	29
Nikko Securities	BBFS	21	0	0	0	0	12	0	0	0	0	0	32
	FBBS	23	0	0	0	0	0	0	0	0	0	0	23
Kitz	BBFS	0	0	6	0	0	0	0	0	0	6	0	12
	FBBS	0	0	6	16	0	0	0	0	0	22	0	44
Dai-Ichi Pharmaceutical	BBFS	38	0	0	0	0	0	0	0	0	0	0	38
	FBBS	18	0	0	0	0	0	0	0	0	0	0	18
Nissan Motors	BBFS	4	0	0	0	0	0	0	0	0	0	0	4
	FBBS	5	0	0	18	0	0	0	0	0	15	0	38
Nippon Paper	BBFS	0	28	0	0	0	0	0	0	0	0	0	28
	FBBS	0	0	0	0	0	0	0	0	0	0	10	10
Daikin Kogyo	BBFS	19	0	0	0	0	0	0	3	0	0	0	22
	FBBS	15	0	0	0	0	0	0	0	0	0	0	15
Ebara	BBFS	17	0	0	0	0	0	0	0	0	0	0	17
	FBBS	6	0	0	9	0	0	0	0	0	0	0	15
Nippon Tokushu Togyo	BBFS	0	0	0	0	0	18	0	0	0	0	0	18
	FBBS	0	0	0	0	0	14	0	0	0	0	0	14
Daito Chemical	BBFS	0	9	4	11	0	0	0	0	8	0	0	31
	FBBS	0	1	0	0	0	0	0	0	0	0	0	1
SMC	BBFS	9	9	0	0	0	0	0	0	0	9	0	26
	FBBS	0	0	0	0	0	0	0	0	0	0	5	5
Matsushita Denko	BBFS	17	0	0	3	0	0	0	0	0	0	0	19
	FBBS	11	0	0	0	0	0	0	0	0	0	0	11
Koa Kasai Marine	BBFS	0	0	4	0	0	0	0	0	0	0	0	4
	FBBS	0	0	27	0	0	0	0	0	0	0	0	27

Source: Tamiya, 1997.
Note: The Bank of Tokyo Mitsubishi is not included owing to the effects of the merger.
BBFS: Bank buying firm shares; **FBBS:** Firm buying bank shares.

Conclusions

The financial system of Japan, in particular its banks, has been going through a crisis that may well spell profound changes. A long process of financial liberalization and increased competition among banks and with financial markets gave large firms more financing options. If the main bank relationship ever worked at all, it certainly stopped working by the 1990s. Banks made unprecedented numbers of poor loans, which turned into bad debt that had to be covered out of capital. Moreover, with stock prices falling and given the role of stock holdings in capitalization, banks had increasing difficulty meeting the ratio of capital to assets required under the Basel Accord. This put pressure on banks to curtail lending, which especially hit smaller domestic firms with fewer financing alternatives, reducing their earnings capacity and thus stock prices, further reducing the value of bank capital owing to the cross shareholding and so on in a vicious downward spiral. Moreover, as the international credit ratings of Japanese banks fell in response to these difficulties, it became more difficult to raise foreign-currency funds abroad. Indeed, Japanese banks were forced to close many of their overseas operations, while foreign direct investors have entered the Japanese market in unprecedented scale.

Government has responded to the crisis with additional policy measures, as the extent of the difficulties gradually came to be better understood. These included technical measures, such as relaxing the reporting requirements of banks so as to no longer require that shareholdings be regularly “marked to market”. In 1999, the measures also included having Government-owned banks, including the Bank of Japan, the Japan Development Bank and the Export-Import Bank, add liquidity to the market by lending to firms, buying commercial paper and providing foreign exchange for financing imports. Furthermore, through the use of Government-controlled pension funds, the Government has carried out so-called “price keeping operations” to keep the stock market afloat, while at the same time offering capital injections to banks to restore their liquidity.

The Government has also taken steps to ease the unwinding of cross-shareholding. That is, one possibility for dissolving cross-shareholding is for a firm to repurchase its own shares. This was not allowed until a series of revisions of the Commercial Code beginning in October 1994 that then permitted stock repurchase programmes by March 1998. As of May 1998, 644 companies listed on the Tokyo Stock Exchange had announced repurchase programmes and were enjoying stronger share prices than the rest of the market.

In the midst of these changes in Japanese (and global) financial systems, the prospects for bank-firm cross-shareholding are unclear. Japanese firms increasingly have market alternatives to banks for funds and depositors increasingly have market opportunities for placements of funds. Arm’s length, market-related financial transactions seem less amenable to the kinds of relationships that bank-firm cross-shareholding characterized.

However, business in Japan is typically conducted within highly contextualized sets of relationships and opaque rules that govern access and accountability. Thus far, there is little evidence of devolution in mutual shareholding arrangements on the part of banks, especially by regional banks whose clientele have very traditional notions of business relationships. For the banks, we can conclude that two significant purposes of cross-shareholding exist: to maintain stable business relationships, i.e., transactional relations between the cross-shareholding partner companies, in other words, as a franchise to do business with each other; and second, to maintain capital adequacy standards. Firms, on the other hand, are today buying bank shares generally only if they are in difficulty and need to preserve their relationship with a bank. Cross-shareholding thus continues to provide implicit relational contracts, a function that still has a role in Japanese business society.

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