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Market liquidity and bank-dominated corporate governance: Evidence from Japan

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ABSTRACT

This paper investigates the relationship between market liquidity and bank-dominated corporate governance structure of Japanese listed firms, represented as main bank relationships and cross shareholdings. We find that (i) main bank lending relationships increase market liquidity and reduce asymmetric information in the Tokyo Stock Exchange and (ii) foreign shareholdings are positively related to market liquidity and negatively correlated with asymmetric information. This suggests that the bank monitoring mechanisms would take a substitute information production role for block holder monitoring role in the market-oriented corporate governance countries like the US.

1. Introduction

Under separation of ownership and control, large-block shareholdings of one shareholder can be used to exploit other shareholders (La Porta, Florencio, Andrei, & Vishny, 1998; La Porta, Lopez-de-Silanes, & Shleifer, 1999; La Porta, Florencio, Andrei, & Vishny, 2000; Shleifer & Vishny, 1997). In widely held firms, the monitoring of shareholders with large stakes in a company might induce higher agency costs because of their superior private information between managers and investors. Under these separated ownership structure prevailing in the US, block shareholders decrease market liquidity because they have access to private information among investors and their trading increases market risk (Heflin & Shaw, 2000; Rubin, 2007). In contrast, the recent evidence for the US reported by Brockman, Chung, and Yan (2009) exhibits no adverse liquidity effects of these block shareholders after controlling the impact of their trading activity. Different from Anglo-Saxon countries such as the US, which establishes widely held ownership, Japan is known as the country with the highest degree and extent of bank-centered corporate governance. Its corporate governance structures are differently characterized as main bank relationships of lending and shareholdings and stable ownership represented as cross shareholdings (Aoki, 1990; Prowse, 1990, 1992) and are controlled by these stable and long-term shareholders. In this paper, we aim to ascertain how market liquidity and information asymmetry are affected by these features of main bank relationships and ownership structures in Japanese listed firms.

Concentrated ownership structure tends to present problems of lower quality of disclosure and lack of transparency. For example, Attig, Fong, Gadhoum, and Lang (2006) show that large ultimate control rights can be expected to induce poor disclosure in Canadian firms, which results in their poor liquidity because larger shareholdings of the ultimate shareholders are associated with their selfish behaviors. Lower disclosure problems worsen asymmetric information problems in financial markets

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and result in reducing market liquidity (Glosten & Milgrom, 1985). In closely held firms, larger ultimate owners of the firm minimize or delay disclosure to increase the probability of ultimately executing their plans (Chau & Gray, 2002). Seven eastern Asian countries aside from Japan have characteristically concentrated ownership structures and poor disclosure problems (Fan & Wong, 2002).

Japanese main bank relationships are known as delegated monitoring of main banks for other creditors and stakeholders (Aoki, Patrick, & Sheard, 1994; Morck & Nakamura, 1999). Two possibilities exist for the effectiveness of main bank monitoring. One possibility is that the main banks contribute to reduction of information asymmetry and increase of market liquidity because private information might be gathered through main bank relationships. In other words, main bank monitoring activities would be expected to take a substitute role of reducing the information asymmetry problems between managers and outside investors. Their monitoring cost might be rewarded by monopoly rents of the main bank relationship. On the other hand, the main bank's superior information might expand the information asymmetry among investors and instead reduce market liquidity. Consequently, main banks might take a role of enhancing information asymmetry problems among outside investors.

Japanese ownership structure is different from separated ownership structure like the US and typically represented as cross shareholdings. The cross shareholding represents firms which mutually hold stocks with other companies for long periods. Managers of firms with more cross shareholdings tend to be more selfish and minimize disclosure because the stable cross shareholdings are a kind of managerial entrenchment device preventing managers from hostile takeovers and proxy fights. Therefore, we can predict that Japanese cross shareholdings are causes of poor disclosure and poor market liquidity.

Furthermore, the unstable shareholders have higher demands for disclosure and would facilitate decreasing information asymmetry and increasing market liquidity. Financial deregulation after the 2000s might affect Japanese Corporate governance systems. For example, Japanese Laws restrict financial shareholdings of less than 5% of outstanding shareholdings. This restriction weakens the main bank stake ties directly. It might reduce the incentive of information production of main banks as stakeholders. In addition, the unstable shareholders, represented as foreign shareholders, increased during this period. Previous study like Ahn, Cai, Hamao, and Ho (2005) only examined the relation between bank shareholdings and asymmetric information in Japanese financial market. Therefore, the relations of asymmetric information in financial markets and main bank relationships have not sufficiently examined. In addition, we also consider for the effect of foreign ownership which increases by the effect of recent financial deregulation.

Our empirical results are summarized as the following points. First, main bank lending relationships take the role of increasing market liquidity and reducing information asymmetry in the financial market, but we cannot gain clear relations between main bank stake relationships and both of market liquidity and information asymmetry. Therefore, the delegate monitoring and information production of main banks have functioned only for lending relationships. In addition, greater foreign shareholding is positively associated with market liquidity and it does reduce information asymmetry. Finally, we cannot ascertain a clear relation between market liquidity and cross shareholders.

The remainder of our manuscript is organized as follows. We describe the recent Japanese corporate governance and reform of the Tokyo Stock Exchange in Section 2. Section 3 presents measures of market liquidity, our hypotheses, and methodology. Additionally, we explain our data and data sources in Section 4. Section 5 presents interpretations of our empirical results and also attempts to solve simultaneous problems. Finally, we conclude this paper in Section 6.

2. Background for Japanese corporate governance

Recent changes of Japanese corporate governance and circumstances of financial markets are stable past the mid-2000s. An important transition occurred then: introduction of market-oriented systems under bank-dominated corporate governance systems. In that sense, the implications of our analyses are also expected to be important for the implication of many countries of corporate governance transition era. After 2008, the influences of global financial crisis would be largely affected for the situation. Therefore, it is invaluable to investigate the periods following these regulation changes and corporate governance in 2007.

In contrast to other market-oriented corporate governance countries, Japan has been characterized by its bank-dominated and stable cross shareholdings during the 1990s (Aoki, 1990; Aoki et al., 1994). A main bank acts as the largest lender and shareholder for the client firm.[1] Another traditional Japanese corporate governance feature is stable cross shareholdings. Stable shareholdings are similar to those in other eastern Asian countries (Claessens, Djankov, & Lang, 2000). Especially during the 1990s, Japanese corporate ownership is characterized by stable cross shareholdings among *Keiretsu* memberships and the main bank stock holdings (Dow & McGuire, 2009; Morck, Nakamura, & Shivdasani, 2000).

Recent Japanese corporate governance has been altered gradually by financial deregulation (Hoshi & Kashyap, 2010). After the 2000s, financial deregulation, which induces some ownership changes, occurred. First, the regulation of a main bank stock holdings was decided and the main bank stock holdings were restricted to less than 5%. Secondly, financial industries are reorganized by the effects of bad deficit problems. The 13 large city banks were merged into three *mega-banks* in 2005: Mitsubishi UFJ, Sumitomo Mitsui Banking Corporation, and Mizuho Financial groups. These financial deregulation measures and reforms were expected to result in the decrease of their stable shareholdings. Furthermore, deregulation encouraged an increase of foreign ownership.[2] In fact, the foreign ownership in 2007 was about 14%: more than double that of 2002, which was about 6.3%. This marked increase of non-stable shareholders is naturally regarded as an indicator of enhanced market liquidity.

1 A long-term relationship between a firm and a particular bank from which the firm obtains its largest share of borrowing (Aoki et al., 1994)).

2 Sakawa, Moriyama, and Watanabel (2012) find that foreign shareholders take a role of providing more executive incentives in Japan.