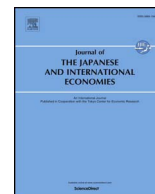




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journal homepage: www.elsevier.com/locate/jjieThe decline in bank-led corporate restructuring in Japan: 1981-2010[☆]Takeo Hoshi^{a,*}, Satoshi Koibuchi^b, Ulrike Schaefer^c^a Stanford University and NBER, United States^b Chuo University, Japan^c University of California, San Diego, United States

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ABSTRACT

Using a unique dataset on all major corporate restructuring events in Japan between 1981 and 2010, we assess changes in the role of the main bank in guiding corporate turnarounds, and the economic consequences of these changes for distressed firms. We identify firms in distress among all listed firms based on accounting data, and we separately identify firms undergoing corporate restructuring based on a newspaper search for the Japanese term “*saiken*”. Even though the ratio of distressed firms has not declined, the incidence of *saiken* restructuring by such firms has become less frequent after the 1990s, indicating a decline in the governance and rescue role of the main bank. When firms undergo *saiken*, they adopt real adjustments in terms of labor, assets and finance. While the intensity of these adjustments has also declined over time, *saiken* firms make more significant adjustments than distressed firms that do not undergo restructuring. The role of *saiken* was an important part of corporate renewal in Japan, and it has declined. In line with existing research, these findings underscore changes in Japanese corporate governance, in particular regarding the decline of the monitoring and restructuring function of the main bank.

1. Introduction

Corporate governance in Japan used to be characterized by the important role played by main banks. A firm's main bank was usually its largest lender and also one of its largest shareholders. The close relationship between the main bank and the client firm was often cemented by long-standing and historical affiliations. It was not uncommon for (retired) executives from the main bank to assume a position on the firm's board of directors. When a firm fell into financial trouble, it was widely expected that the main bank would intervene and launch a turnaround plan. While such interventions were called “rescue operations”, usually the main bank did much more than offer financial help to its troubled client (such as debt forgiveness, interest rate reduction, or new loans). The main bank also dispatched executives to lead a restructuring process, which often also included reorganization measures such as labor force adjustment, asset divestitures, business segment exits, consolidation, and management replacement. In that sense, main bank rescue operations were comprehensive corporate turnaround episodes, and they have been shown to be effective in

turning firms around (e.g., Aoki and Patrick, 1994; Pascale and Rohlen, 1983; Morck and Namamura, 1999; Hoshi and Kashyap, 2001).

Beginning in the 1980s, this system began to change. Financial deregulation expanded corporate financing options for large Japanese firms (e.g., through bond issues at home and abroad) which substantially altered the main bank relationship (Hoshi and Kashyap, 1999). As large firms reduced their dependence on their main banks, the banks' governance role was reduced, as banks found themselves with less access to corporate information as well as revenues from these clients. The banks responded by broadening their business to new, smaller borrowers, and in the absence of long-standing relationships they demanded collateral, mostly in the form of real estate. In the 1990s, after the “bubble economy” burst and stock and land values collapsed, bank rescue interventions became less frequent and less effective (Hoshi and Kashyap, 2001, Chapter 5; Hirota and Miyajima, 2001). In the absence of feasible alternatives to bank turnarounds, such as legal restructuring processes for Chapter 11-type bankruptcy procedures, this decline in the role of banks in corporate restructuring of troubled firms created a void, which has been

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considered an important factor in the emergence of zombie firms (e.g., Caballero et al., 2008; Peek and Rosengren, 2005).

This paper takes a systematic look at all major episodes of bank-led corporate restructuring in Japan during the 30 years from 1981 to 2010, in order to assess changes in the incidence, efficacy and performance implications of bank rescue operations over time. Our analysis is based on an original dataset of restructuring episodes of listed firms that we created by coding information on each case, including financial data and turnaround measures taken, such as management turnover, business reorganization, divestitures, and many more. This dataset allows us to (1) compare firms undergoing restructuring with distressed firms that do not, and thereby assess whether the role of main banks in leading corporate turnarounds has declined over time; (2) analyze the changing nature of turnaround measures (such as duration and content); and (3) measure changes in post-restructuring performance over time to assess the economic impact of banks on corporate restructuring.

This paper refines and expands the analysis in our earlier paper (Hoshi et al., 2011), which used the same database but for odd-years only, and for the years 1981 to 2007 only. This paper adds to our understanding of corporate restructuring in Japan in three major ways. First, the database has been expanded to include all years between 1980 to 2010. Second, as explained in detail in Section 4 below, we have refined the definition of a *saiken* episode by looking into the details of each case to identify the length of a multi-year restructuring episode. This allows new analyses of duration and post-*saiken* performance. Third, we conduct a clearer analysis of the differences between distressed firms that undergo *saiken* and those that do not. While we confirm all main findings of our earlier work, we also add new insights, especially on the length and intensity of restructuring episodes.

We begin in Section 2 with a brief background and review of select papers on Japanese corporate governance, with a focus on bank-led restructuring of troubled firms. Section 3 offers a brief description of changes in bank-firm relations due to financial deregulation, to set the stage for the statistical analysis. Section 4 introduces the dataset, and Section 5 reports the results of the statistical analyses. Section 6 concludes.

2. The role of banks in Japanese corporate governance

There is a sizable amount of research on corporate governance in Japan, in particular regarding corporate control and management oversight. This research has documented many characteristics that differ from the stylized shareholder-oriented corporate governance of Anglo-Saxon countries. For example, rather than occupying a dominant place in the governance system, shareholders were usually considered as just one of several stakeholders with equal (if not less) standing to other stakeholders such as workers, creditors, suppliers, customers, or even local communities. Many of the important stakeholders in Japan were “insiders” with long-standing relationships with the firm. For example, the board of directors – which in the Anglo-Saxon textbook view is a prime locale for management monitoring – has long been dominated by insiders in Japan.

Banks assumed a prime position among the stakeholders. The primary reason for their elevated role was that until the mid-1990s, Japanese firms were highly leveraged, and most of their external financing was in the form of bank loans.¹ The main bank of each firm became the nexus of information gathering, and other lenders followed the main bank's lending decisions, trusting that in times of crisis the main bank would lead a turnaround effort and assume a larger portion of liabilities. The main bank was incentivized to do so, given that it was typically the largest lender and a significant shareholder. Sheard (1989,

1994) argued that this system of delegated monitoring among main banks was the functional equivalent of the market for corporate control in Japan until the 1990s.

In spite of these differences, Japan's corporate governance often produced results similar to those in the Anglo-Saxon system. For example, executive turnovers in Japan were associated with factors very similar to those in the U.S., including falling stock prices and declining profits. Kaplan (1994) observed that executive turnovers were associated more with stock market indicators than with employment or asset growth in both, Japan and the U.S. In other words, Japan's corporate governance system was often as effective in terms of monitoring management and enforcing executive turnover as in the U.S.

Other studies confirmed the importance of banks in Japan's corporate governance. Hoshi et al. (1990) looked at the performance of firms with close bank ties after the onset of financial distress. They found that firms with close ties to a main bank recovered more quickly than other firms, as measured in sales or investments. Kaplan and Minton (1994) showed that banks played an important role in forcing out incumbent managers of distressed firms, and that falling stock prices or declining profits triggered the dispatch of bank executives into a client's management team. Moreover, firms with bank executives as managers or directors were more likely to experience top executive turnovers. Kang and Shivdasani (1995) confirmed that falling stock prices or accumulating losses led to non-routine CEO turnovers. This link between poor performance and executive turnover was especially strong for firms with close main bank ties, and often the new CEO was an executive from the main bank or a group-affiliated firm. Performance also improved faster in firms with close main bank ties.

In sum, research suggests that until the 1980s, Japan's corporate governance system, while different in many ways from the Anglo-Saxon approach, worked effectively by putting the main bank in charge of monitoring firms, replacing management of poorly performing firms, guiding effective restructuring, and improving the performance of troubled firms.

3. Financial deregulation and changes in bank-firm relations

The situation began to change in the late 1980s. Until the 1980s, Japan's financial system was heavily regulated, in terms of rigid barriers to corporate fund raising in capital markets, both within Japan and abroad. Only a select group of Japan's largest firms were allowed to issue bonds, there were no short-term notes, and the stock market was governed by restrictions that limited its usefulness for many firms. Thus, even Japan's largest firms had to rely on bank loans for external financing. This resulted in very high leverage, with an average debt-equity ratio of 6 for listed firms in the 1970s (Schaeede 2008, Chapter 6). In the 1980s, the onset of slow, step-wise financial deregulation opened the door for the largest firms to issue securities. As this process continued throughout the 1980s, many large firms reduced their dependence on bank loans. For the banks, this meant the loss of their largest customers, with whom they had long-standing relationships.

At the same time, much slower deregulation of retail banking meant that deposits (the banks' largest source of funds) kept flowing in. As Hoshi and Kashyap (1999) show, deregulation to expand investment options for savers progressed much more haltingly than those that expanded corporate finance options. Banks could have responded by purchasing government bonds, for example, but the late 1980s was also a time when the Japanese government pushed for fiscal consolidation and budget deficit reduction. Banks had to turn to new clients for their corporate lending. These were often smaller firms, with which they had neither a long relationship nor good ways to assess business conditions. To reduce the new risks, banks focused on lending to small- and medium-sized firms that could pledge collateral. During the “bubble economy” of the late 1980 and fast-rising property values, real estate was considered especially desirable.

When the speculative boom (and land prices) collapsed in the early

¹ See Hoshi and Kashyap (2001, Chapter 4), Hoshi et al. (1990), Sheard (1989), Schaeede (2008), and Sekine et al. (2003).

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