Cross-Shareholdings Decline for the 11th Straight Year (FY 2001 Survey)

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1. Introduction

Compared to an earlier time when cross-shareholding relationships flourished, the environment today continues to change rapidly—the comprehensive introduction of mark-to-market accounting for financial products (from April 2001), decline in stock prices as seen by the Nikkei average's falling below 10,000 (in September 2001) for the first time since 1984, and the new law limiting shareholdings of banks (effective January 2002). Meanwhile, policies have been quickly implemented to prevent the rapid unwinding of cross-shareholdings from destabilizing the market—exchange traded funds (ETF) were inaugurated in July 2001 to help invigorate the market, the Commercial Code was revised in October 2001 to lift the ban on treasury stocks, and the Banks' Shareholdings Purchase Corporation was established in January 2002. Furthermore, stocks purchased during specified periods are eligible for capital gains tax breaks.

The emergency economic policies announced in April 2001, which formally declared the shareholding restriction for banks, cited several objectives—to ensure the soundness of banks by limiting the market risk of bank shareholdings within their risk management capacity, to vitalize the stock market, and to enhance corporate governance. This marked a departure from the previous policy, which focused narrowly on avoiding market turmoil from the unwinding of cross-shareholdings, and offered only temporary fixes.

With the decline in long-term shareholders, companies are increasingly being exposed to shareholders' proposals from active shareholders. Though not necessarily pleased by such intervention, corporate management must strive to earn the trust of institutional investors concerned about fiduciary duty.

In light of the environmental changes described above, this paper discusses the rapidly changing scene in cross-shareholdings based on the results of the Fiscal 2001 Cross-Shareholding Survey.

2. Description of the FY 2001 Survey

(1) Survey Method

The latest survey marks the sixth survey to be released since fiscal 1996. During that time, we have revised our survey method to accommodate changes in accounting and corporate systems, enabling us to compile a time series data base that dates back 15 years to fiscal 1987.

Data on the ownership structure of Japan's equity markets is obtained from the *Shareownership Survey* (National Conference of Stock Exchanges). This data covers the full postwar period, and reveals the changing characteristics of the ownership structure in recent years. The latest survey (fiscal 2001) finds that ownership among banks and business companies has declined to 30.5%, while ownership among pure investors such as foreigners and pension trusts is expanding.

Our survey of cross-shareholdings is based on data from the Ma*jor Shareholders Data* (Toyo Keizai Inc.) and detailed portfolio holdings data from financial statements (*Yuka Shoken Meisaihyo*, Nikkei QUICK Information Technology Co.). Shareholding relationships that have been identified are investigated and tallied. Since our survey is based on published data, the inadequacy of data coverage is an unavoidable problem. Still, the survey's main characteristic is that it pieces together various holding relationships to identify intentional cross-shareholding relationships.

1. Survey Coverage

The survey covers all companies listed on the nation's securities exchanges at the end of the fiscal year (March),[1] as well as companies that have been delisted due to planned mergers or other reason at the beginning of the new fiscal year.[2] The number of listed companies increased by 66 in fiscal 2001 from the previous fiscal year due to IPOs and entries from over-the-counter markets, totaling 2,668 companies (2,660 listed companies, plus 8 companies about to be merged). The market value of common shares listed by these companies—the focus of our survey—reached ¥313 trillion (a ¥55 trillion decline from the previous fiscal year).

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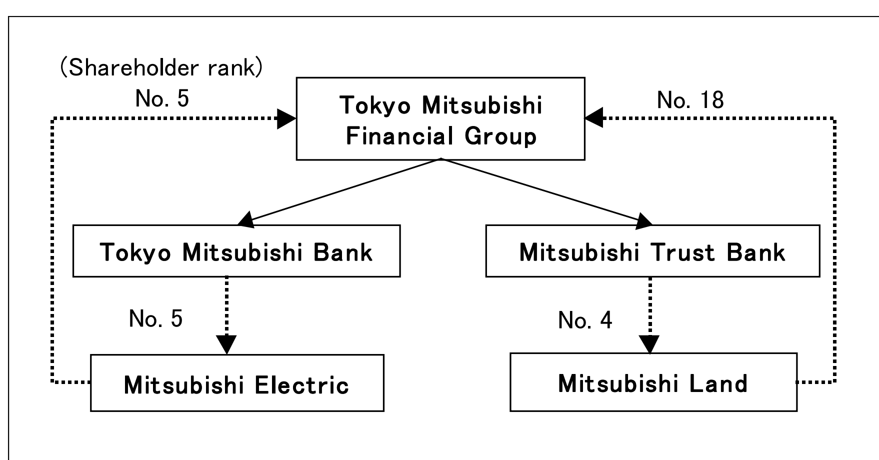
[1] Since shareholder composition changes greatly around the time of release, we exclude companies not listed at the final settlement date prior to the observation date.
[2] We consider the effect of companies delisted at the fiscal yearend due to corporate reorganization on time series data continuity. By our definition, for example, Tokio Marine Fire and Insurance Co. is included in the fiscal 2001 survey.

2. *Definition of Cross-Shareholding*

The distinction and recognition of cross-shareholdings is based on whether shareholding relationships among registered shareholders are mutual. However, with regard to shares registered in the name of trust banks and contributed to pension funds as a retirement benefit trust, and shareholdings held through holding companies following a corporate reorganization, we distinguish cross-shareholdings based on actual (not nominal) mutual shareholding relationships.[3] For example, Tokyo Mitsubishi Financial Group, through its affiliation with Tokyo Mitsubishi Bank, clearly has a cross-shareholding relationship with Mitsubishi Electric (Figure 1).

Figure 1 Example of Cross-Shareholding Through a Holding Company



Source: Compiled by NLI Research Institute from Major Shareholders Data *(Toyo Keizai Inc.).*

3. *Aggregation Method*

When cross-holding relationships are identified among companies, we count all shares being mutually held as cross-shareholdings.[4] We then calculate the overall cross-shareholding ratio as the value of cross-shareholdings in the sample to the overall market.

Aggregate results are tallied at the end of March in two ways: by market valuation, and by volume (number of transaction units of shares). While market valuation can be regarded as an appropriate measure of these holdings, we also refer to the volume-based results because of the unavoidable effect of price fluctuations when comparing time series data.

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[3] If a company contributes its shareholdings to the pension assets of a retirement benefit trust, although shares will be registered in the name of the trust bank, the company can retain control over voting rights.
[4] Shares registered in the name of trust banks cannot be completely separated from the trust account, are thus are not recognized as cross-shareholdings.

4. Survey Results

Beginning in the March 2000 period, the scope of disclosure was narrowed for portfolio holdings data. To remove this effect and enable comparison of time series data, we measured "estimated values" by constraining the scope of observation.[5] Our survey results show estimated values up to fiscal 1999, and observed values from fiscal 2000, which are measured using all available data.

(2) Cross-Shareholding and Long-Term Shareholding Ratios

1. Cross-Shareholding Ratio

The fiscal 2001 survey confirmed cross-shareholdings among 2,330 companies (87% of the sample). Because companies tend to have multiple cross-shareholding relationships, the number of such relationships reached 18,500. As of the end of March, the market valuation of these cross-shareholdings was ¥27.9 trillion, marking a significant decline of ¥9.4 trillion from the previous year. As a result, the ratio of cross-held shares to all listed shares (value-based cross-shareholding ratio) fell to 8.9%, the first drop below 10% level since the survey was begun. Compared to the previous year, the ratio fell 1.3 percentage-point, marking the eleventh straight decline since fiscal 1990.

Even considering how the nature of recent IPOs (in which the parent company or owner retains majority control) has changed the quality of the survey sample, the decline in cross-shareholding ratio has been conspicuous in recent years. Compared to the peak in the late 1980s, when cross-shareholders absorbed massive secondary offerings at market value, the ratio has plunged by more than half.

The volume-based ratio (by number of transaction units) of 9.1% is close to the value-based ratio. Due partly to significant stock splits among companies that have no cross-shareholdings, the volume-based ratio declined by 1.6 percentage-point from the previous year.[6] As with the value-based ratio, this marks the eleventh straight year of decline. The decline in both ratios confirms that cross-shareholding is shrinking regardless of the measure used.

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[5] Constraints consist of the change in disclosure format of the financial statement regulations from fiscal 1999 (scope of disclosure of the detailed securities holdings data, and abolition of the detailed securities holdings data of related companies), and the perceptible range of the previous fiscal year's data.

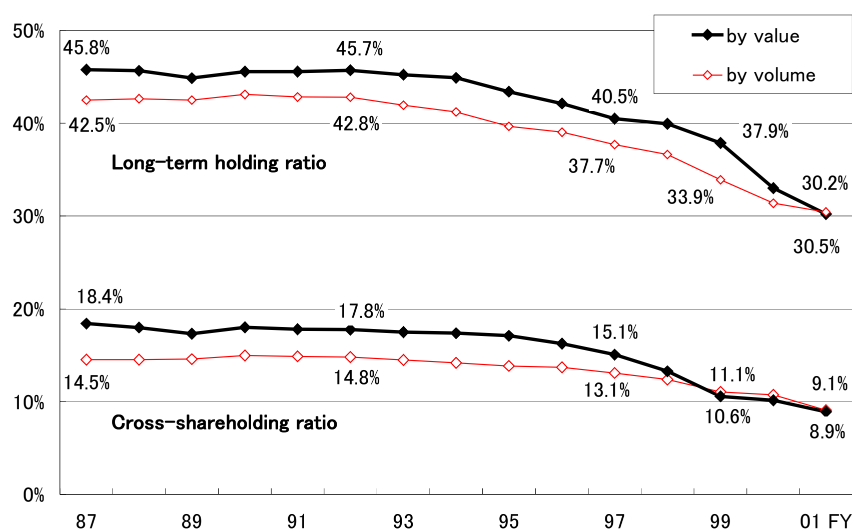
[6] In fiscal 2001, NTT Docomo's 5-for-1 stock split had a particularly large impact. After the split, the company's proportion of transaction units to the market rose from 1.6% to 6.6%.

2. *Long-Term Shareholding Ratio*

To maintain or expand financial relationships, companies do not always resort to cross-shareholding; they may also form stable long-term holding relationships based on mutual consent. We defined "long-term shareholdings" to include cross-shareholdings, non-cross-held shares involving financial institutions,[7] and shares held by listed affiliated companies. We then calculated the ratio of long-term shareholdings to the overall market (for holdings of financial institutions, we used the results of the *Shareownership Survey*).

At the end of fiscal 2001, the ratio was 30.2% on a value basis (2.8 percentage-point decline from the previous year), and 30.5% on a transaction unit basis (0.9 percentage-point decline). As with the cross-shareholding ratio, the long-term shareholding ratio, which began declining in the mid 1990s, shows no sign of abating.

Figure 2 Cross-Shareholding and Long-Term Shareholding Ratios



Source: NLI Research Institute

(3) Composition of Long-Term Shareholders

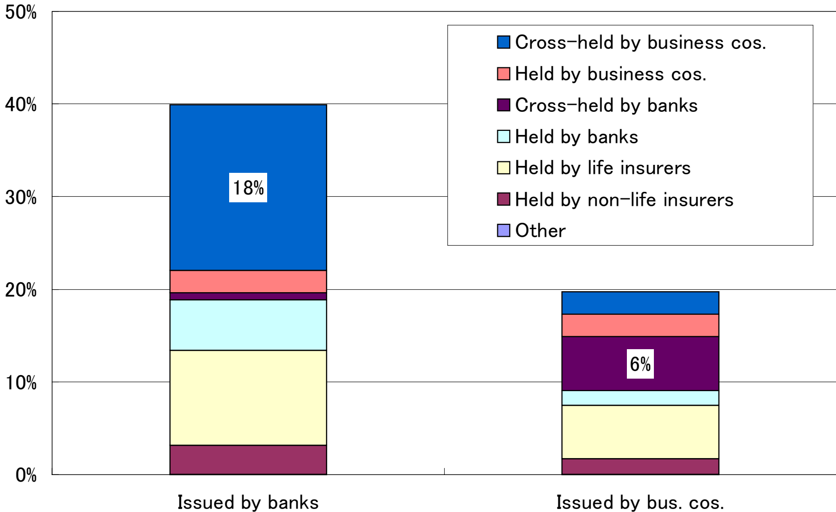
At the end of fiscal 2001, the composition of cross-shareholding patterns was led by bank cross-holdings of business company shares (51% of total cross-shareholdings), followed by cross-holdings among business companies (24%), and business company cross-holdings of bank shares (14%). Clearly, banks play a central role in the structure of cross-shareholding.

Next, looking at the composition of long-term shareholders of banks and business companies—excluding listed subsidiaries and affiliates—we confirmed that 40% of bank

[7] Financial institutions include domestic banks (excluding trust banks), and domestic life and non-life insurers.

shares (excluding trust banks, but including holding companies) are held by listed companies and financial institutions, of which 18% are cross-held by business companies. On the other hand, 20% of business company shares are long-term holdings, of which 6% are cross-held by banks (Figure 3). As the results show, banks rely heavily on long-term shareholders, particularly cross-shareholders.

Figure 3 Composition of Long-Term Shareholders by Share Issuer



Source: NLI Research Institute

(4) Trends Among the Six Major Corporate Groups

While apprehension about industrial domination no longer exists, interest remains strong regarding trends among the six major corporate groups. According to a survey by the Fair Trade Commission on how businesses view the consolidation of large banks across group affiliations (asking businesses that receive financing from consolidated banks about the impact on industry), few businesses believe that corporate groups are disappearing. While bank consolidations make it more difficult to understand the corporate groups and compare time series data, our data's continuity from the past reveals cross-shareholding patterns in the six groups.[8]

The cross-shareholding ratio for group companies stood at 14.1% for fiscal 2001, far above the 8.9% ratio of the overall market and 6.8% for companies that do not belong to corporate groups. In particular, the ratio for cross-holdings contained within groups is 6.6%, meaning that approximately half of cross-shareholdings are dependent on the group. In recent years,

[8] Consists of members of the presidents clubs contained in the Fair Trade Commission's *Seventh Survey Report on the Status of Corporate Groups*. However, we also added the holding companies (such as Tokyo Mitsubishi Financial Group) to which group companies are affiliated.

despite instances of unwinding and revision of cross-holding relationships within groups, fundamental changes have not yet occurred.

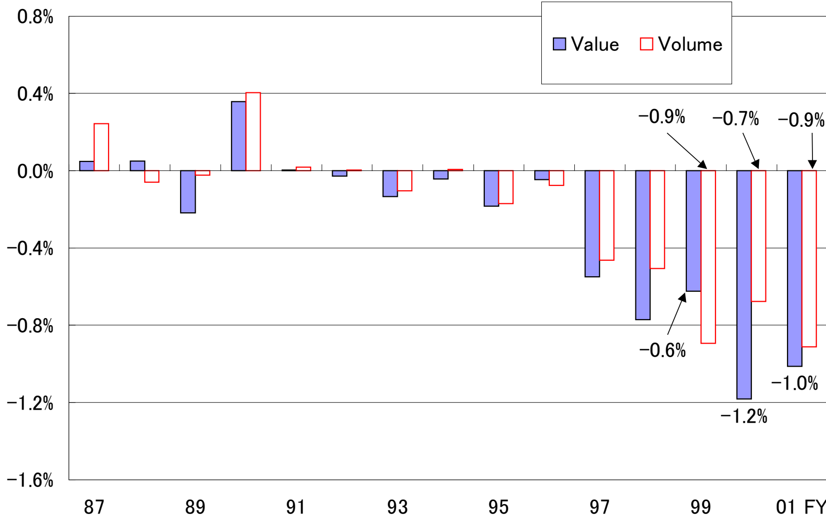
3. Status of Unwinding of Cross-Shareholding

(1) Factor Analysis Reveals Unwinding of 1%

Since the cross-shareholding ratio is affected by the aggregation method and changes in the sample universe from listings and delistings, fluctuations in the ratio may not accurately reflect the status of unwinding. Thus we applied a simple factor analysis and extracted factors that indicate actual unwinding. We identified five factors: (1) change in each company's weighting, (2) change in each company's cross-shareholding ratio, (3) the mutual effect of the first two, (4) new listings, and (5) delistings. The sum of factors 1 and 2 is regarded as the change due to actual unwinding of cross-shareholdings (Figure 4).

For fiscal 2001, on both a value and volume basis, actual unwinding contributed −1 percentage-point to the change. Since the cross-shareholding ratio is almost 10%, this means that approximately 10% of cross-shareholdings were sold off or became one-sided.

Figure 4 Actual Unwinding of Cross-Shareholding



Source: NLI Research Institute

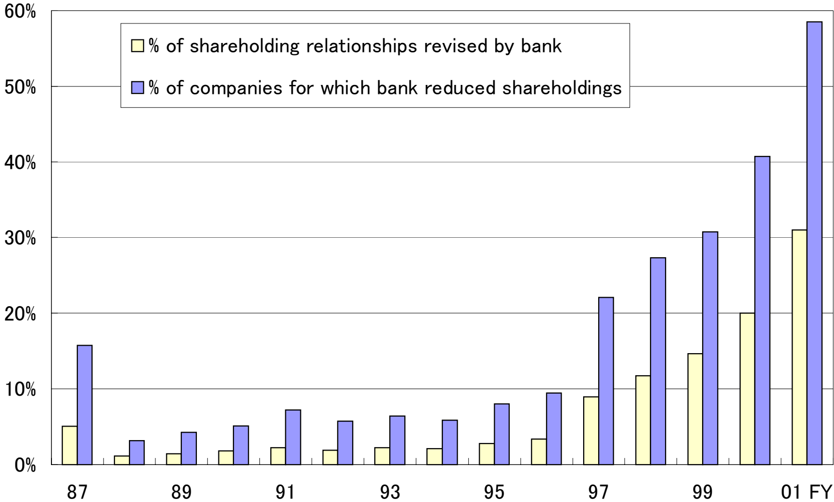
(2) Banks Overhaul Shareholding Relationships

The sale of shares held by banks has attracted keen interest of late. Our time series data confirms that banks (city banks and long-term credit banks) have indeed been altering their shareholding relationships. Starting with a sample of TSE first section companies at the end

of fiscal 1986, we tracked the proportion of shareholding relationships that banks—as major shareholders of companies—have reduced from the previous year (left bar in Figure 5).[9] Until the early 1990s, banks had reduced only about 2% of their shareholding relationships (the other 98% remaining unchanged or increasing), thus bolstering their reputation as long-term shareholders. However, from fiscal 1997, the proportion gradually rose, reaching 31% in fiscal 2001 (26% excluding Tokyo Mitsubishi Bank's ETF contribution), showing that banks had seriously begun altering their shareholding relationships.

Moreover, since companies generally have several banks as major shareholders, we also tracked the proportion of companies whose shares had been sold off by at least one bank, and found that banks had sold off shares in approximately 60% of companies in fiscal 2001 (right bar in Figure 5). Indeed, over the past five years, 80% of companies have had their shares sold off by banks.

Figure 5　Banks Become Reluctant Major Shareholders



Note: Covers 971 companies listed on the TSE first section at the end of fiscal 1986. Shareholders are major banks excluding trust banks.
Source: NLI Research Institute

The law restricting shareholdings of banks, which went into effect early this year, calls for banks to reduce shareholdings to satisfy the BIS Tier 1 capital requirement by September 2004. During fiscal 2001, while the major banks used ETFs and other means to shed over ¥5 trillion yen of shareholdings, capital adequacy ratios continued to suffer from the disposal of bad loans and assessed stock losses. At the end of fiscal 2001, excess shareholdings still accounted for approximately ¥7 trillion (equivalent to almost 30% of shareholdings). The major banks thus plan to trim another ¥5 trillion of shareholdings in the present fiscal year.

[9] Considering stock splits and mergers of surveyed companies, bank mergers, and scope of the *Major*

4. Feasibility of Alternatives to Absorb Unwound Cross-Shareholdings

(1) Treasury Stock Authorization Stimulates Share Repurchases

Under the Commercial Code revision that took effect in October 2001, companies became able to hold shares that they have repurchased (Figure 6). In addition, the legal reserve requirement has been eased, substantially expanding the freedom to buy back shares. Following the law's revision, as of the end of August 2002, approximately 1,200 listed companies had decided at their annual general meetings to establish share repurchase programs for common shares, with their boards of directors authorizing ¥9 trillion in repurchases. However, counting only those companies whose boards had implemented a repurchase program (for write-off purposes) prior to the revision, the amount is only ¥3 trillion.[10]

For instance, at its annual general meeting in June, Sony established a share repurchase program of 90 million shares, valued at ¥650 billion. But like many other companies, Sony responded to the revised law by simply renewing the same repurchase limit as under the previous special measure for cancellation of shares (which was consistent with its articles of incorporation).[11] Moreover, some cases defy reason—even as large banks struggle to meet capital adequacy ratios, UFJ Holdings established a share repurchase program of 300,000 shares (equivalent to 6.27% of issued shares).

While the ¥9 trillion share repurchase total needs to be heavily discounted, we must also note that the authorization of treasury stocks has in fact changed the perception of companies. Since treasury stock entails neither dividends nor voting rights, it is almost no different from the previous system of writing off shares; yet more companies have been repurchasing shares and holding them as treasury stock since the ban was lifted in October 2001. In addition, in July, after the annual general meetings, business corporations became large net investors, indicating that the law's revision could be affecting the stock market's supply and demand environment.

For institutional investors, treasury stocks pose a problem in that they affect the weighting of the TOPIX investment benchmark. But the fact that companies are optimistic about share repurchases (with a treasury stock objective) to unwind cross-shareholdings is a bright sign.

Shareholders Data, we counted only cases in which a 1% decline or more in shareholdings could be confirmed.

[10] Some companies who executed their first share repurchases after the Commercial Code revision have already exhausted their limit, such as Yamato Transport's 4.5 million share program (1.0% of issued shares).

[11] While Toyota's repurchase program of 170 million shares also attracted attention, after adding the approximately 180 million shares already repurchased and cancelled, the total is within the 370 million share limit stipulated by the articles of incorporation.

Figure 6 Law Revisions Regarding Share Repurchases

Year	Revised law	Main points
1994	Commercial Code revision	Repurchase approved for specified objectives, such as share write-off out of profits, and transfer to employees' shareholding plan (based on AGM resolution)
1997	Commercial Code revision	Repurchase approved for stock options
1997	Law concerning special measures under the Commercial Code for cancellation of stock	If allowed by articles of incorporation, repurchase approved for share write-off out of profits (based on board resolution)
1998	Revision of special measures for cancellation of stock	Repurchase approved for share write-off out of capital reserve (until March 2000; extended to March 2002)
1999	Revison of Law Concerning Revaluation of Land	Repurchase approved for write-off from revaluation of land value
2001	Commercial Code revision	1. Restrictions lifted regarding objectives and quantity 2. Restrictions lifted on holdings

Source: Compiled by NLI Research Institute

(2) Contributing Shares to ETFs

For financial institutions that need to shrink their large and varied shareholdings, the exchange traded fund (ETF) offers an expeditious alternative. Several such cases have been reported involving financial institutions in the Tokyo Mitsubishi group. Financial institutions can create an ETF by contributing their shareholdings, and then sell the ETF instead of trying to sell shares directly in the market. A major advantage of the ETF is that shares can be contributed regardless of the business condition or liquidity of individual issues, making the ETF an effective scheme for unwinding cross-shareholdings in large lots. Since the market risk of ETFs can be hedged using index futures, ETFs can be sold gradually over a period of time. In addition, securities companies involved in forming ETFs have been known to cooperate in reselling them. Of course, if investors merely invest in an ETF as a substitute for individual shares, the overall impact on the stock market will be neutral. The key to success for ETFs is to emphasize their advantages and generate new demand from investors.

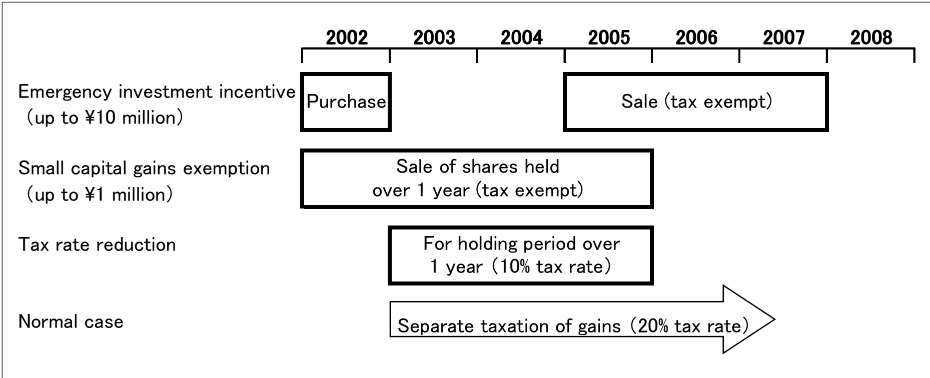
(3) Individual Investors are Unresponsive

Equity markets are counting heavily on participation by individual investors. Measures to attract them include the reduction in minimum transaction size, and tax incentives that specify the timing of purchases and sale—which, as it happens, coincides with the implementation of shareholding limits for banks in September 2004 (Figure 7).

However, these measures alone are unlikely to attract individual investors. A survey by the

Cabinet Office (*Opinion Survey on Securities Investment*, conducted this May and released in August) found that most respondents do not intend to invest in stocks (82.7%) or investment funds (87.5%) in the future. In addition, almost 90% do not intend to investment in government bonds or corporate bonds. With so little interest in securities investment among individuals, more substantive measures will be needed to entice them into the market.

Figure 7 Tax Incentives for Individual Investors



Source: Compiled by NLI Research Institute

(4) Banks' Shareholdings Purchase Corporation

In preparation for the upcoming restriction on bank shareholdings, the Banks' Shareholdings Purchase Corporation was established as a temporary receptacle to prevent market chaos when banks sell off their massive shareholdings. The corporation, which began operating this February, has purchased only a small amount of shares, and appears to be of limited usefulness. With regard to purchases from the general account, which are premised on the creation of ETFs or share buybacks by issuing companies, the corporation's need to intermediate is unclear. On the other hand, purchases from the special account require a contribution of 8% of the sale price. Thus even if banks can take the shares off their balance sheets and meet the holding restriction, they still face the risk of a stock price decline corresponding to the contribution, leaving the shares a risk asset under BIS standards. Although postponed in the last Diet session, further enhancements are desperately needed, such as expanding the scope of purchases to shareholdings of business companies.

5. Conclusion

The reduction of shareholdings and unwinding of cross-shareholdings, which are centered around financial institutions, will continue for the time being. Of course, as the objectives of unwinding cross-shareholdings are fulfilled—to accommodate the shareholding restriction,

contain market risk, and improve capital efficiency—the pace is expected to decline. The holdings that have been sold off first were probably the most expendable, and as the diversity of shareholdings decreases, index-like ETFs will become more difficult to create. Thus going forward, there is great apprehension as to whether shareholdings can be further reduced and the aims of unwinding cross-shareholdings fulfilled.

In the survey mentioned earlier, many individuals shunned stock investment. Though the public's pessimistic investment stance might be compensated for by the intermediary functions of financial institutions, these very deposit and insurance institutions are the largest sellers of shares, and moreover are entangled in capital ties with each other. Investors are chilled by the unstable market conditions stemming from the unwinding of cross-shareholdings, while foreign investors are troubled by accounting and corporate governance problems. Thus no significant fund inflows are anticipated into equity markets other than public pensions.

Under these conditions, companies that must unwind cross-shareholdings have no assurance of being able to find investors. Although stock prices can quickly adjust to offset the scarcity of investors, we must avoid the worst case scenario in which the liquidation of shareholdings—intended to avoid market risk—actually drive prices downward. The Banks' Shareholdings Purchase Corporation, created as a safety net to avert this situation, needs to be prepared to deal with such contingencies.

Moreover, given the widespread existence of cross-shareholding, the amount of capital that companies truly need is not clear. If a company's capital originally grew excessive due to cross-shareholdings to ensure control of management, it is reasonable to seek a more appropriate size by repurchasing shares. Companies must recognize the cost of capital and initiate action, while shareholders can facilitate unwinding by exercising their shareholders' rights and encouraging companies to repurchase shares. However, the problem of repurchasing shares not an easy one, as many companies have already spent the capital raised from cross-shareholding on business fixed investment.

To survive the race for capital, companies must win the confidence of investors by improving management efficiency, and increasing the transparency and integrity of management. In addition, the market can do its part to promote recovery by driving out companies not fit for investment, and approaching a market size that suits the level of capital providers.