The Relationship of Companies and Banks as Cross-Shareholdings Unwind —Fiscal 2002 Cross-Shareholding Survey

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1. Introduction

Falling stock prices have hampered corporate performance. Fiscal 2003 ended in March with the Nikkei stock average slumping to levels not seen in two decades. Led by bank shares, equity holdings saw large valuation losses, ultimately putting many companies in the red. The stock market's steep decline wiped out much of the gains from diligent restructuring efforts, and awakened corporate managers once again to the inherent risk of equity ownership.

Since the fiscal crisis of 1997, when falling stock prices revealed the risk of holding bank shares, companies have had many occasions to revise their holdings of bank shares, including bank restructurings and the introduction of mark to market accounting for financial products. In the process, some companies quickly liquidated their holdings of bank shares, but the majority have maintained conventional ties with banks and left bank shareholdings intact. However, calls for a freeze on mark to market accounting—a position advocated in political circles after the recent stock market decline—were not echoed by participants in economic circles. Corporate managers apparently realized that juggling balance sheets does not change the harsh reality, and actually produces negative consequences.

For a long time, the structure of shareholdings in Japan was dominated by long-term corporate shareholders (*antei kabunushi*). Basically, reciprocal shareholding relationships existed wherein a small number of banks with superior capital strength were major shareholders of a large number of business corporations, who in turn owned bank shares. However, this structure has become increasingly difficult to maintain due in part to shareholding restrictions imposed on banks (not to exceed Tier I capital). Financial institutions made great strides in reducing shareholdings in fiscal 2002, particularly with the Bank of Japan's new share purchase program helping major banks to sell off ¥6.4 trillion of shares, more than the initial plan of ¥5 trillion.

But while banks have been liquidating shareholdings, the response of business corporations has not been as clearcut despite the severe impact of plunging bank share prices. Indeed, companies have even reaffirmed their bank ties in many cases by cooperating to help boost the capital of banks.

Based on the results of the latest Survey of Cross-Shareholding, we first analyze the current status of cross-shareholding, which is widely known to be unwinding rapidly. We then examine developments in corporate shareholdings of bank shares—a critical factor in predicting future cross-shareholding behavior.

2. FY 2002 Survey Results

1. Methodology

1. Data

The basic data for the survey is derived from *Major Shareholders' Data* (Toyo Keizai Inc.) and the schedule of securities in financial reports submitted to the Ministry of Finance (*Yuka Shoken Hokokusho Fuzoku Meisaihyo*, obtained from Nikkei QUICK Information Technology Co.). This data is used to investigate mutual shareholdings among companies. Since the survey relies on publicly released data, the scope of coverage is limited, but the fact that the survey can also examine the relationships of individual companies is a significant advantage. Incidentally, the data for the fiscal 2002 survey is estimated to capture over 80% of the actual value of all bank shareholdings, based on the aggregate shareholdings value of the banking sector obtained from the *2002 Shareownership Survey* (National Conference of Stock Exchanges).

2. Survey sample

Reference date: End of March 2003 (for fiscal year 2002)

Companies covered: Includes companies listed on all domestic stock exchanges as of the reference date,[1] and those no longer listed due to a planned merger at the start of the following fiscal year (excluding JASDAQ).[2] The fiscal 2002 survey covered 2,674 companies, an increase of six companies from the previous fiscal year.

Shares covered: Includes common shares issued by listed companies (excluding NTT and other shares held by the government). In the fiscal 2002 survey, the total market

[1] Since shareholder composition can change significantly when a company becomes listed, we excluded companies not yet listed as of the last settlement date prior to the reference date.
[2] Regarding companies delisted at fiscal yearend due to reorganization, we considered the impact of observations on the continuity of time series data. For this reason, in the fiscal 2002 survey, we included Nissho Iwai and Nichimen.

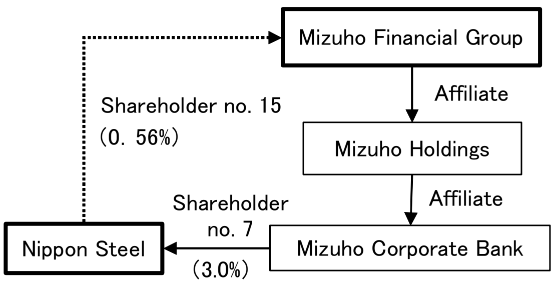
capitalization of these shares was ¥237 trillion (¥77 trillion less than in the previous fiscal year), and total volume was 900 million unit shares (150 million unit shares more than in the previous fiscal year).

Shareholders covered: Includes the surveyed companies and unlisted domestic financial institutions (banks and insurance companies). These shareholdings are analyzed in the survey of relationships of individual companies (however, shares held by trust banks are excluded from totals because shares held in trust accounts cannot be completely separated out).

3. Definition of cross-shareholding

Cross-shareholdings are said to exist when two companies mutually hold each other's shares. All such shares on both sides (even if shareholdings are not balanced) are defined as cross-held shares. In principle, mutual or reciprocal relationships exist between two companies. However, considering the growing diversity of organizational forms, in the case of holding companies, we determined that cross-shareholdings can exist indirectly if a substantive mutuality exists. For example, in the relationship between Mizuho Financial Group (MFG) and Nippon Steel, we determined that, cross-shareholding exists in substance, and thus counted all MFG shares held by Nippon Steel, as well as all Nippon Steel shares held by MFG, as cross-shareholdings (Figure 1).

Figure 1 Example of Cross-Shareholding at a Holding Company



Source: Compiled from Toyo Keizai Inc., *Major Shareholders Data*, March 2003.

Moreover, shares that companies contribute as pension assets to employee pension trusts—which are registered in the name of the trust bank[3]—are treated the same as shares directly held by companies because these holdings also involve corporate ties, and are held primarily as long-term holdings.

The cross-shareholding ratios reported below are measured as follows: as of the reference date, we first estimated the total number of applicable shares held by shareholders covered

[3] While shares held in trust are registered in the name of the trust bank, under the employee pension trust agreement,

in the survey. We then identified all shares by type of holding,[4] and calculated the ratio of cross-held shares in the total. To avoid misinterpreting trends, we calculated the cross-shareholding ratio on both a value basis (market valuation on the reference date) and volume basis (unit share).

4. Definition of long-term shareholding

Even when a mutual shareholding relationship does not exist, shareholdings are often maintained over a long period by agreement for policy purposes such as to maintain or expand business relationships. We define these as long-term shareholdings, which include "shares issued or owned by financial institutions" and "shares held by related listed companies" (such as parent firms), and measured the long-term shareholding ratio. In measuring the long-term shareholding ratio for the overall market, to compensate for the incomplete coverage from measuring holding relationships individually, we used the results of the *Shareownership Survey* for data on shares held by financial institutions.

2. Survey Results for Fiscal 2002 Yearend

From the above data, we confirmed approximately 42,000 shareholding relationships among shareholders covered in the survey, of which 17,000 were mutual. These reciprocal shareholdings—or cross-shareholdings—comprised a market valuation of ¥17.6 trillion at the end of March, marking a significant decrease of ¥10 trillion from the previous fiscal year, and the lowest level observed since the survey was begun in fiscal 1987. The value-based cross-shareholding ratio of 7.4% (down 1.5% from fiscal 2001) calculated for the overall market, along with the volume-based ratio of 7.2% (down 1.9% from fiscal 2001), are both new lows as well. As the results indicate, the ratio of cross-held shares in the domestic stock market has declined considerably. Nonetheless, we should note that the ¥17.6 trillion value of cross-shareholdings, which exceeds the market capitalization of listed banks (¥16.3 trillion), is still a considerable size.

Similarly, the long-term shareholding ratio also declined significantly, falling to 27.1% (down 3.1% from fiscal 2001) by value, and to 26.0% (down 4.5%) by volume. These declines are consistent with the fact that financial institutions have been large net sellers.

Among individual companies, we found that cross-shareholding still remains firmly rooted. In the fiscal 2002 survey, 85% or 2,281 companies are confirmed cross-shareholders. Among the 1,615 companies whose ownership is diversified (the principal shareholder has less than

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companies can maintain voting rights.

[4] Toward the end of fiscal 2002, since many bank customers received preferred bank shares, we determined that a cross-shareholding relationship exists even though one side consists of preferred shares, and counted only the common shares held by the other side in the cross-shareholding total.

a 20% ownership), 93% or 1,508 companies are confirmed cross-shareholders.

Moreover, of the 1,615 companies with diversified ownership, after excluding financial institutions, who often have numerous cross-shareholdings with many business corporations, almost all of the remaining 1,506 companies have several cross-shareholding relationships, with one company having over 60 relationships (Figure 2).

Figure 2 Histogram of Cross-Shareholdings per Company

Source: NLI Research Institute

Of course, companies can also own shares in other companies for investment purposes. However, this alone would not explain why so many companies have multiple cross-shareholding relationships; we can only conclude that companies routinely assume shareholding risks in exchange for having their own shares held long-term by other companies.

3. Implications of Time Series Data[5]

The time series data for cross-shareholding and long-term shareholding ratios shows that both ratios have consistently declined since the 1990s. The cross-shareholding ratio has declined for twelve straight years on both a value and volume basis; the value-based ratio's decline over this period exceeds 10 percentage points. Moreover, the decline was slow at first—only 0.9 percentage points over the five-year period to fiscal 1995—but expanded in the late 1990s, and continues to do so today.

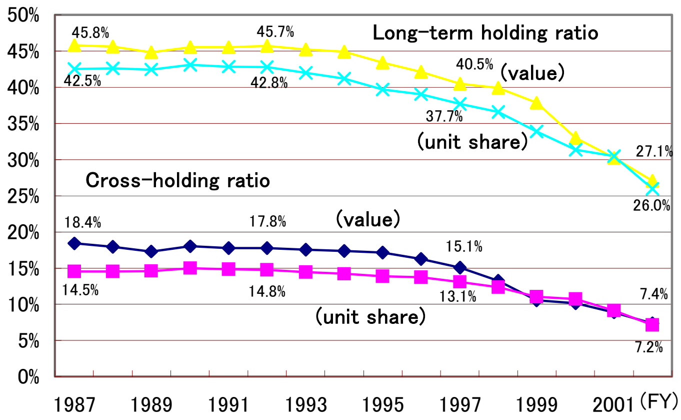
However, the time series data also indicates that not all of the conspicuous decline in both

[5] For comparison purposes, to eliminate the effect of the reduced disclosure requirements for detailed tables of financial statements from the March 2000 period, we recalculated the time series data from previous years by restricting the data set to conform with new disclosure rules in regulations concerning financial statements from fiscal 1999 forward. The released figures are thus recalculated estimates up to the fiscal 1999 survey results, and observed values calculated from all available data from fiscal 2000 forward.

shareholding ratios for the overall market can be attributed to the unwinding of cross-shareholding. Another important factor is the stock market's changing composition as new companies emerge who are not bound by conventional shareholding practices. This significantly reduces the weight of banks and old-economy companies in the stock market, who depend heavily on long-term shareholders (that is, have a high long-term shareholding ratio).

Figure 3 Cross-Shareholding and Long-term Shareholding Ratios of the Overall Market

	Cross-holding ratio		Long-term holding ratio	
FY	Value	Unit share	Value	Unit share
1987	18.4%	14.5%	45.8%	42.5%
1988	18.0%	14.5%	45.7%	42.7%
1989	17.3%	14.6%	44.9%	42.5%
1990	18.0%	15.0%	45.6%	43.1%
1991	17.8%	14.9%	45.6%	42.8%
1992	17.8%	14.8%	45.7%	42.8%
1993	17.5%	14.5%	45.2%	42.0%
1994	17.4%	14.2%	44.9%	41.2%
1995	17.1%	13.9%	43.4%	39.7%
1996	16.3%	13.7%	42.1%	39.0%
1997	15.1%	13.1%	40.5%	37.7%
1998	13.3%	12.4%	39.9%	36.6%
1999	10.6%	11.1%	37.9%	33.9%
2000	10.2%	10.7%	33.0%	31.4%
2001	8.9%	9.1%	30.2%	30.4%
2002	7.4%	7.2%	27.1%	26.0%



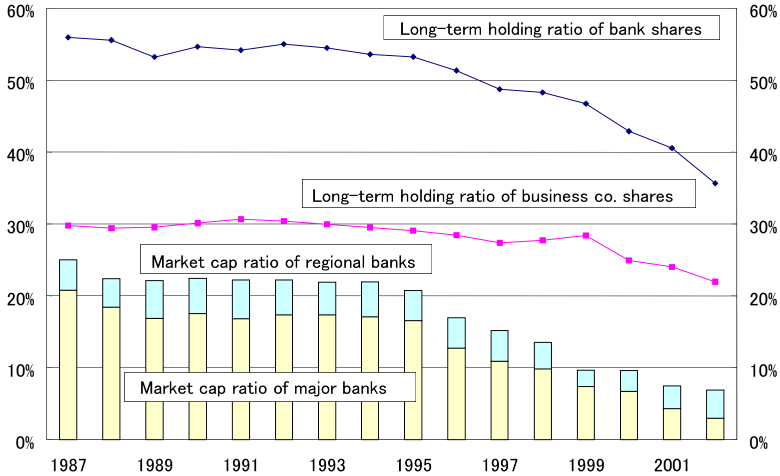
Source: NLI Research Institute

For example, as Figure 4 shows, the long-term holding ratio of bank shares is much higher than of business corporation shares. However, due to the plunge in bank share prices, their ratio to total market capitalization has declined significantly compared to business corporation shares. Obviously, this decline in the market capitalization ratio of bank shares has significantly impacted the overall market's long-term shareholding ratio.[6]

However, the decline in market capitalization ratio of companies that depend heavily on long-term shareholders may not be a mere coincidence. Recent research on corporate governance indicates that since the 1990s, companies that are dominated by long-term shareholders and resistant to outside shareholders have performed poorly in business results and enterprise value. If this observation is correct, regardless of how cross-shareholding unwinds, the decline in cross-shareholding ratio caused by declining share prices could not be averted.

[6] The same effect is observed with the volume-based long-term holding ratio. Companies with a high share price or who are eager to expand their base of investors have reduced the unit size of investment.

Figure 4　Long-term Shareholding Ratio & Market Capitalization Ratio of Bank Shares and Business Corp. Shares



Source: NLI Research Institute

4.　Sale of Bank Shares by Business Corporations

While the declining market weight of bank shares has pulled down the cross-shareholding and long-term shareholding ratios of the overall market, company documents confirm the fact that among corporate shareholders, financial institutions in particular have reduced their shareholdings significantly. On the other hand, selling activity by business corporations, and particularly their stance on selling bank shares, is not clear. Thus we separated out cross-shareholding relationships between major bank groups and business corporations, and observed changes in individual relationships (Figure 5).

Figure 5　Unwinding of Cross-Shareholdings by Bank Groups and Business Corporations

Cross-shareholdings of banks and business corps. at start of period	3,506	
of which, cross-shareholdings unwound by banks	1,577	(45%)
of which, business corporations who:		
also unwound cross-shareholdings	1,127	(71%)
did not unwind cross-shareholdings	222	(14%)
unwinding status is unknown	228	(14%)

Notes: Includes the four major bank groups and Resona. "Unwinding status is unknown" means that shareholdings became exempt from disclosure and were unconfirmed, possibly due to stock price decline rather than sale.
Source: NLI Research Institute

Looking at the cross-shareholding relationships of 2,441 business corporations listed on stock exchanges in fiscal yearend 2001 and 2002, we find that of the confirmed cross-shareholdings with large bank groups at the end of fiscal 2001, bank groups reduced their stake in 45% of cross-shareholdings during fiscal 2002. Thus business corporations retained their bank shares, but were still unable to keep banks from unilaterally unwinding reciprocal shareholdings. In contrast, at least 70% of business corporations whose shares were unwound by banks chose not to unwind any of their reciprocal holdings of bank shares. For the majority of companies, the unwinding of cross-shareholdings with banks was thus one-sided, and on the side of banks.

In fact, *Shareownership Survey* results by industry show that business corporations (including unlisted companies) still own 31.4% of all bank shares, down only 1.2% from the previous fiscal year. This supports the finding that cross-shareholdings in fiscal 2002 were being unwound largely on the side of banks.

3. Unwinding Method of Cross-Shareholding

Several possible explanations come to mind as to why business corporations have not followed the banks in unwinding cross-shareholdings: they may have already consolidated their holdings of bank shares; they may want to avoid posting large losses from the sale of severely devalued bank shares; or they may be unable to sell bank shares because the bank has an upper hand in the business relationship. A more detailed analysis is thus required.

We looked at the range of available of selling methods as a possible explanation for the difference in unwinding activity by the two sides. In fiscal 2002, for example, UFJ Holdings sold ¥1.4 trillion in shareholdings as follows: 37.8% to the Banks' Shareholdings Purchase Corporation (BSPC) and Bank of Japan (BOJ), 24.8% in block trades, 22.5% to companies repurchasing their own shares, and only 14.9% in the open market (data is obtained from the company's fiscal 2002 financial statements). Other prominent examples include in-kind subscriptions to exchange traded funds by Mitsubishi Tokyo Financial Group, and numerous secondary offerings such as by Sumitomo Trading (July 2002) and Sharp (December 2002). In fact, the banking sector as a whole sold only ¥1.5 trillion in shares through the stock market, which is a small portion of the total sales. In this way, banks have numerous selling methods at their disposal, and can liquidate positions without increasing the float of the share issuer. By contrast, business corporations are limited in how they can liquidate their bank shares. Below we discuss limitations further by examining examples of share purchases by the BSPC and BOJ, and share repurchases by issuers.

1. Share Purchases by BSPC and BOJ

Commercial banks have access to two policy-based share purchase programs—the Banks' Shareholdings Purchase Corporation (BSPC), which began operating in February 2002, and the Bank of Japan's share purchase program, which began in November 2002. Under last year's law revision, business corporations became eligible to sell bank shares to the BSPC in

January 2003 under the condition that if the bank first sells its shareholdings to the BSPC, the business corporation can sell up to one-half that value of reciprocal bank shareholdings.

However, since banks have chosen to sell shares to the BOJ purchase program, which began later (as of August 31, 2003, purchases totaled ¥1.67 trillion), the BSPC (whose purchases totaled ¥218.1 billion as of April 25, 2003) could not function as a buyer of bank shares from business corporations.

But considering that the BOJ may discontinue the share purchase program after September, and that banks who fulfill requirements of the banks' shareholding restriction law become ineligible for the BOJ purchase program, the BSPC's role will grow in the future. Moreover, the revision of the banks' shareholding restriction law in August eliminated the greatest hurdle for banks—the 8% contribution to the BSPC at the time of sale[7]—so that banks are more likely to use the BSPC program.

Figure 6 Share Purchase Programs of the BOJ and BSPC

	Bank of Japan Share Purchase Program	Banks' Shareholdings Purchase Corporation (special account) and Banks' Shareholding Restriction Law	
		After law revision	Before law revision
Purchase period	September 2003	September 2006	September 2006
Purchase limit	¥3 trillion	¥2 trillion	¥2 trillion
Purchase from other than bank	None	Up to full amount sold by bank, if issuer applies within 6 months of bank's sale of shareholdings	Up to one-half amount sold by bank, if issuer applies within 6 months of bank's sale of shareholdings
Contribution at time of sale	None	Repealed	8% of BPSC's purchase price
Purchase limit per bank	Amount exceeding Tier I capital (max. ¥750 bil.)		
Shares eligible for purchase	・Listed shares (excl. financial instit.) ・Long-term debt rating of BBB or better ・¥20 billion+ in annual turnover	・Listed and OTC shares ・Long-term debt rating of BBB or better	・Listed and OTC shares ・Long-term debt rating of BBB rating or better
Purchase limit per issuer	Lesser of 5% of voting rights, or amount based on rating and annual turnover (max. ¥100 billion)	10 times average monthly turnover	5 times average monthly turnover
Purchase limit per issuer from any one bank		Limit repealed	Average monthly transaction amount
Disposal of purchased shares	Sept. 2007～Sept. 2017	Once purchase is completed, shares to be disposed of slowly after an adequate period. Until 2019.	Until 2012
Will exercise voting rights	Yes	Yes	Yes

Source: Compiled from various sources.

Moreover, the BSPC's purchase limit for bank shares from business corporations was raised to the same amount as the reciprocal shareholdings purchased from banks. In the future, as banks increasingly use the BSPC, the BSPC can play a more active role in buying bank shares from business corporations.

2. Share Repurchases

Ever since the treasury stock ban was repealed in the Commercial Code, a growing number

[7] One of the problems with using the BSPC was that since banks had to contribute an additional 8% of the sale amount as an investment in the BSPC, shareholding risk could not be completely eliminated, and thus remained classified as risk assets under BIS rules.

of companies have initiated share repurchase programs. In our survey, as of the end of June 2002, 1,196 companies were authorized by shareholder resolutions to repurchase ¥9.8 trillion in shares, and 822 companies had repurchased shares totaling ¥3.1 trillion.

Many of the share repurchase programs appear to have intentionally coincided with the massive sale of shares by financial institutions. Focusing on business corporations, we examined the relationship between shareholder resolutions authorizing share repurchases, and the sale of shares by major banks (Figure 7). At most companies repurchasing shares, we were able to confirm the sale of their shares by banks. This tendency was particularly strong among companies who repurchased a significant amount of shares (84 companies repurchased over ¥5 billion of shares). Share repurchase programs benefit not only large companies, who can better defend against takeovers, but their banks, who need to liquidate shareholdings in a hurry. Some measure of cooperation seems to have occurred on the side of business corporations.

Figure 7 Status of Share Repurchases Authorized by Shareholder Resolution

	No. of companies		Repurchase amt. (¥ trillion)	
		(repurchase over ¥5 bil.)		(repurchase over ¥5 bil.)
Business corporations who repurchased shares	779	84	2.95	2.49
of which, banks initially held shares	664	75	2.42	2.02
of which, banks sold shares in period	444	63	2.00	1.69

Notes: Shows total share repurchases authorized by shareholders' resolutions in the period from the Commercial Code revision to June 2002 Bank groups include Sumitomo Mitsui, UFJ, Mizuho, and Resona, and excludes Tokyo Mitsubishi, who contributed to a TOPIX-type ETF. Only shareholdings confirmed by *Major Shareholders' Data* are included.
Source: Compiled from company share repurchase reports, and *Major Shareholders' Data*.

Share repurchases continue to flourish in the current fiscal year (from shareholder resolutions in June), with shareholders at approximately half of the surveyed companies (1,352 companies) authorizing up to ¥8.3 trillion in share repurchases. Companies will enjoy even more freedom under the Commercial Code revision this fall: if permitted by the corporate charter, share repurchases can be authorized by the board of directors single-handedly. Of course, it would be a problem if companies focused solely on repurchasing shares without regard to their financial condition or capital efficiency. But as long as banks sell off shares in large lots, repurchase programs will continue to play an important role.

On the other hand, with large banks still financially shaky and having to raise capital through public fund injections and high-cost preferred shares, business corporations clearly cannot expect banks to authorize share repurchase programs.[8]

[8] Among the major banks, only UFJ Holdings was authorized to repurchase up to 300,000 shares (¥100 billion) last year, but no repurchase was made. A repurchase of up to 300,000 shares (¥50 billion) was authorized again this fiscal year.

4. The Outlook for Corporate Shareholdings

1. Banks Near Shareholdings Reduction Goal

In July, the restriction on banks' shareholdings was extended for two years to September 2006. However, the major banks, whose shareholdings were in excess by ¥7 trillion at the end of fiscal 2001, have for the most part already satisfied the restriction by reducing shareholdings as well as increasing capital in connection with bad loan disposal. In the current fiscal year, the major banks plan to sell off ¥4 trillion in shareholdings. Banks will thus continue to reduce shareholdings, but the pace is expected to gradually slow down.

However, due to factors such as the weak financial condition of issuers and low liquidity of shares, some shares will fail to attract the BSPC or any other buyers, and remain in the hands of banks. Another important issue will be how to manage equity portfolios that are skewed toward companies who represent a large management commitment, particularly considering the increase in shares acquired through debt-equity swaps to rescue ailing companies.

2. Unclear Outlook for Sale of Bank Shares

Due in part to share repurchases, business corporations temporarily become net share buyers for the first time in twelve years, but reverted to being net sellers this May. Thus they basically remain net sellers, and should continue to unwind cross-shareholdings while keeping an eye on share price levels (Figure 8).

However, the relationship between companies and banks remains strong, as seen by the way companies have readily accepted allotments of new preferred shares issued by a major bank.[9] From the schedule of securities in financial statements of companies, we confirmed that in Mizuho Financial Group's recent issuance of preferred shares, 334 companies received allotments, of which at least 266 companies have cross-shareholdings, and 237 have financial dealings with the group.

Moreover, in a separate analysis, the author found that companies are highly averse to selling bank shares when a long-term banking relationship exists in the form of cross-shareholdings or loan financing, and when companies have problems seeking bond financing.[10] Thus bank shares are most durable as shareholdings when a strong banking relationship exists, or when companies are dependent on banks for financing.

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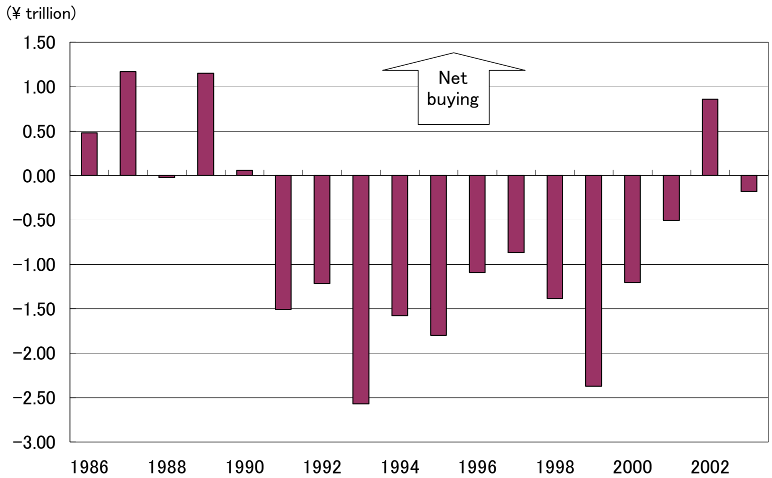
[9] Mizuho Financial Group raised approximately ¥1.1 trillion by issuing 11th series class X1 preferred shares and allotting them to 3,368 companies.

[10] See Fumio Kuroki, "Quantitative Analysis of the Unwinding of Cross-Shareholdings—Multiple Equilibria and Portfolio Deterioration," (in Japanese) *Securities Analyst Journal*, December 2002.

All things considered, business corporations are thus not likely to proceed as far as banks in unwinding their cross-shareholdings.

Figure 8 Net Share Buying by Business Corporations



Note: Shows aggregate for 1st and 2nd sections of the three major exchanges; FY2003 covers April to August.
Source: Compiled from Tokyo Stock Exchange, *Investment Trends by Investor Category*.

5. Conclusion

No full-fledged recovery in share prices is likely without a recovery in the corporate sector and overall economy. Given the bleak outlook for the near future, companies need to isolate corporate performance from stock market volatility, and banks have done a commendable job of this by reducing shareholdings over the past year. On the other hand, the lack of progress by business corporations in reducing their holdings of bank shares is a matter of concern.

Fortunately, since bank share prices have recently been recovering steadily, the decision by companies not to hastily sell off bank shares is turning out to be a good one. Moreover, considering the business environment and other factors, ownership of bank shares may have special significance. But in any case, management must be held accountable for its decision to maintain these shareholdings. This is particularly true for the companies whose banks have unwound cross-shareholdings, because management must now explain itself to a new composition of shareholders and investors.

Moreover, the fact that companies are shareholders of banks has implications for bank management. It remains to be seen whether the BOJ and BSPC, as major shareholders of companies, will exercise their shareholder rights and encourage management to sell off bank shares. But until the fate of bank shares becomes clear, the problem of cross-shareholdings will not come to an end.