Recent Developments in Cross-Shareholding

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1. Introduction

Once credited as the driving force of rapid economic growth, Japan's corporate system has come under criticism not only for the magnitude of the bad loan problem at financial institutions, but for loss of confidence related to the main bank system and corporate balance sheets. Stock cross-holding, once regarded necessary for stable management, has also become of questionable value in the wake of the prolonged bear market.

The risks of long-term stockholding, largely ignored during the extended bull market of the 1980s, became apparent when the bubble finally burst and have proved to be highly detrimental to corporate health. For example, in the fiscal year ending March 1998, 16 banks (city, long-term credit, and trust) and five life insurers had switched to a cost-based stock valuation method.

From the viewpoint of market deregulation and global standards of corporate governance, since long-term stockholdings that do not benefit stockholders and companies are intolerable, cross-holding is expected to continue decreasing. Meanwhile, the stock market is strongly concerned that the dissolution of cross-holdings will drive down stock prices.

NLI Research Institute has been conducting regular surveys since fiscal 1996 to monitor the status of stock cross-holding. Below we discuss the results of the latest survey for fiscal 1997 (March 1998).

2. The FY 1997 Cross-Shareholding Survey

(1) Changes in the Survey Method

The survey covers 2,388 domestic listed companies whose fiscal year ended in March 1998. Since the inclusion of OTC companies in the fiscal 1996 survey caused data collection problems that delayed the survey's release until late October, the fiscal 1997 and subsequent surveys are limited to domestic listed companies. Although this reduces the coverage rate from 65 percent to

62 percent, results should not be significantly affected due to the fact that OTC companies are smaller, newer firms with fewer stock cross-holding relationships (Table 1).

Table 1 Changes in Survey Method

Fiscal year	Companies surveyed	No. of companies	Total market valuation	Coverage rate
1996	Domestically listed companies, OTC companies	3,125	¥317.6 trillion	65.0%
1997	Domestically listed companies	2,388	¥308.0 trillion	62.0%

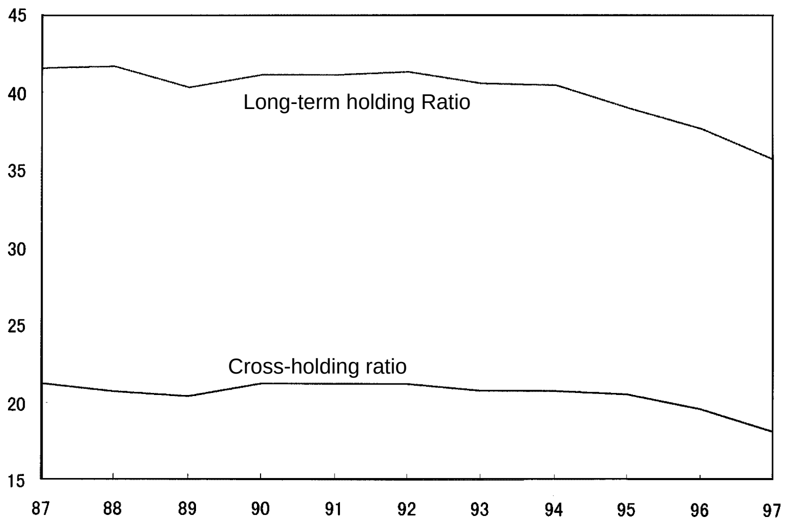
Note: For comparison purposes, total market capitalization (FY96) includes both listed and OTC companies as of the end of FY 97.

(2) FY 1997 Survey Results

1. Accelerated dissolution of cross-holdings

As of fiscal 1997 yearend, the stock cross-holding ratio was 18.18 percent (1.46 points below fiscal 1996), while the long-term stockholding ratio (cross-holding ratio broadly defined) was 35.69 percent (down 1.98 points). These are the lowest levels since the survey was begun, and the declines are also the largest (Figure 1).

Figure 1 Cross-Shareholding and Long-term Holding Ratios



Source: National Securities Exchange Assn.,*Survey of Distribution of Stockholders* (FY 1997); *Yuka Shoken Hokokusho and Hoyu Yuka Shoken Meisaihyo*; and Toyo Keizai Shinposha, *Large Stockholder Data.*

2. Financial institutions begin dissolving cross-holdings

Table 2 sheds light on the pattern of decline in cross-holding ratios. In fiscal 1996, the cross-holding ratio declined by 0.97 percent as business companies decreased their stockholdings in financial institutions by 1.42 percent. In fiscal 1997, business companies continued to decrease these stockholdings, while financial institutions also began reducing cross-holdings by 0.28 percent (Table 2.1).

Table 2.1 Composition of Cross-Holding Ratio (FY 95, %)

Issuer / Stockholder	Financial institution	Business company	Other	Total
Financial institution	0.43	7.09	0.29	7.80
Business company	6.35	4.83	0.21	11.40
Other	0.46	0.92	0.04	1.41
Total	7.24	12.83	0.53	20.61

Table 2.2 Composition of Cross-Holding Ratio (FY 96, %)

Issuer / Stockholder	Financial institution	Business company	Other	Total
Financial institution	0.29	7.63	0.25	8.18
Business company	4.93	4.97	0.20	10.10
Other	0.39	0.94	0.03	1.36
Total	5.61	13.54	0.48	19.64

Table 2.3 Composition of Cross-Holding Ratio (FY 97, %)

Issuer / Stockholder	Financial institution	Business company	Other	Total
Financial institution	0.20	7.46	0.24	7.90
Business company	4.13	4.66	0.23	9.03
Other	0.30	0.92	0.02	1.25
Total	4.63	13.04	0.50	18.18

Note: Because stock price changes affect the ratios, changes do not necessarily correspond to the number of stocks owned.
Source: See Figure 1.

3. Outcome of dissolution of cross-holdings

Using the stock distribution survey results of the Japan Securities Exchange Association, Table 3 shows what has happened to stocks after the dissolution of cross-holdings.

Ultimately, the stock from the dissolution of cross-holdings and long-term holdings appears to be absorbed by foreign investors. However, a closer look reveals stock acquisitions by pension trusts, individuals, and business corporations. These entities raised funds by selling other stocks favored by foreign investors and thus priced higher in the polarized stock market. Since foreign investors are likely to have bought these stocks, acquisition of the formerly closely held stocks is characterized by a dual structure.

Table 3.1 Structure of Stockholdings in the Overall Market (%)

	Long-term holdings		Other corporate ownership	Foreigners	Individuals, government
		of which, cross-holdings			
FY 87	41.53	21.20	33.47	4.12	20.88
88	41.64	20.72	33.74	4.33	20.29
90	41.07	21.19	33.63	4.69	20.74
91	41.08	21.15	32.30	6.04	20.58
92	41.30	21.14	31.34	6.32	21.04
93	40.58	20.79	31.38	7.72	20.362
94	40.51	20.82	31.13	8.11	20.25
95	39.0.	20.61	30.65	10.51	19.81
96	37.67	19.64	31.19	11.54	19.60
97	35.69	18.18	31.55	13.54	19.22

Table 3.2 Change in Stockholdings

(%)

Investor	FY 97	FY 96	Change in value	contributed by:	
				stock vol.	stock price
Bank, life insurance	33.94	35.00	-1.06	-1.91	+0.86
Pension fund	3.84	2.41	-1.43	+0.97	+0.46
Business company	24.64	25.60	-0.96	+0.36	-1.32
Foreigner	13.35	11.94	+1.43	-0.02	+1.43
Individual	19.00	19.39	-0.39	+0.86	-1.25
Other	5.24	5.66	-0.42	-0.38	-0.04

Notes: The change in value of stockholdings can be separated into a ① stock price effect and ② stock volume effect, which are expressed in the table as contributions.

Assume: P Unit cost of stockholdings
N Number of stocks held
t Fiscal year
$\triangle$ Change in value from t-1 to t

The change in value of stockholdings is thus:

$$\frac{P_t \times N_t - P_{t-1} \times N_{t-1}}{P_{t-1} \times N_{t-1}}$$

$$= \frac{(P_{t-1} + \triangle P)(N_{t-1} + \triangle N) - P_{t-1} \times N_{t-1}}{P_{t-1} \times N_{t-1}}$$

$$= \frac{\triangle N}{N_{t-1}} + \frac{\triangle P}{P_{t-1}} + \frac{\triangle P \times \triangle N}{P_{t-1} \times N_{t-1}}$$

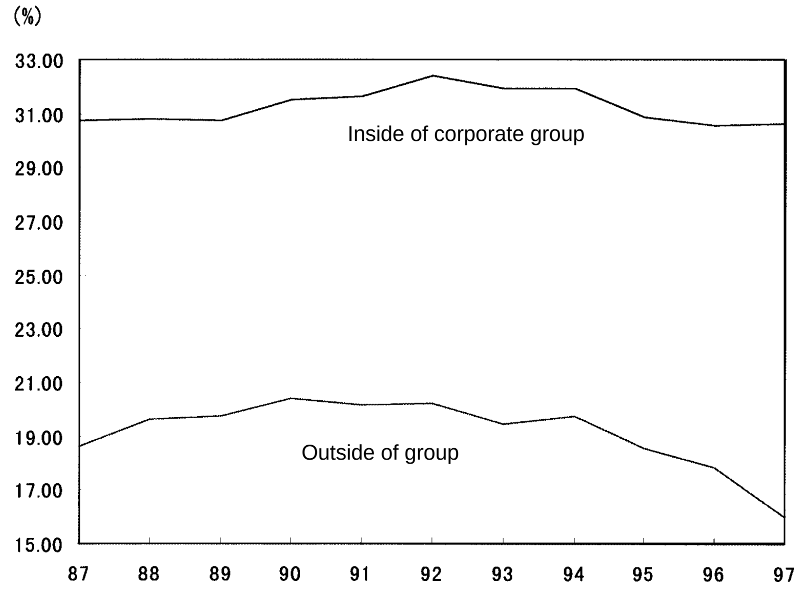
$$= \frac{\triangle N}{N_{t-1}} + \frac{\triangle P}{P_{t-1}} \quad (= ① + ②)$$

Source: Compiled from National Conference of Securities Exchanges, *FY1997 Survey of the Distribution of Share Ownership.*

4. Developments within corporate groups

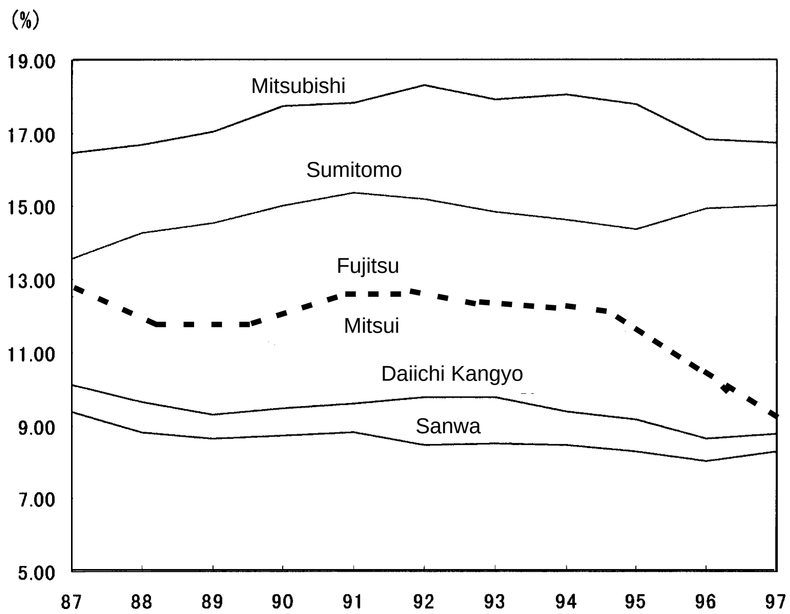
In contrast to the sharp decline in external cross-holdings, cross-holding ratios within corporate groups remain high (Figure 2). However, among corporate groups, the former zaibatsu groups (Mitsubishi, Sumitomo, and Mitsui) tend to have stronger internal ties than bank-centered groups (Fuji, Daiichi Kangyo, and Sanwa). In particular, the decline of the Fuji Bank group's cross-holding ratio is notable (Figure 3).

Figure 2 Cross-Shareholdings Inside and Outside of Corporate Groups



Source: Same as in Figure 1.

Figure 3 Cross-Holding Ratios of Corporate Groups



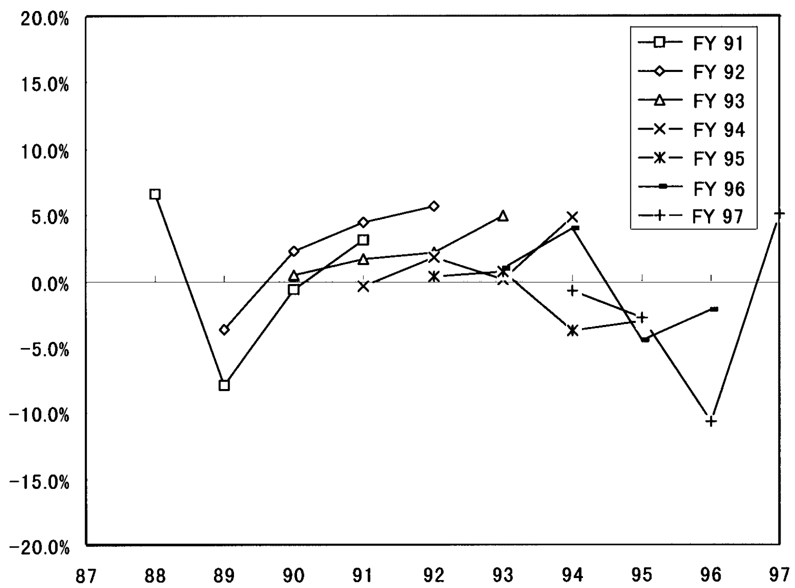
3. Characteristics of Companies that Dissolve Cross-Holdings

To draw a portrait of the companies reducing their cross-holdings, for each year since fiscal 1991, we look at the sales growth, ROE, net assets per share (a measure of stability), and stock performance of 100 companies whose company cross-holding ratio (the ratio of a company's outstanding shares that are cross-held) declined most in each year. For comparison, these values are standardized to the market average and plotted for three to four years prior to the year of greatest cross-holding dissolution. (Figures 4 to 7).

Overall, in addition to the constant concern over returns from stock investments, there is a growing emphasis on the level of risk.

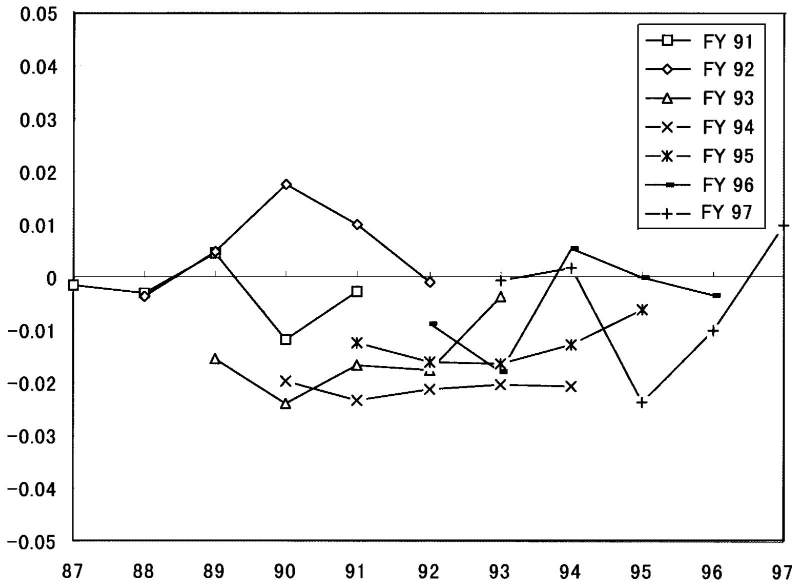
Sales growth: Previously, we observed that cross-holdings declined among companies who outperformed the market in sales growth. Recently, however, the decline is mainly among underperforming companies.

Figure 4 Sales Growth of Formerly Cross-Held Companies



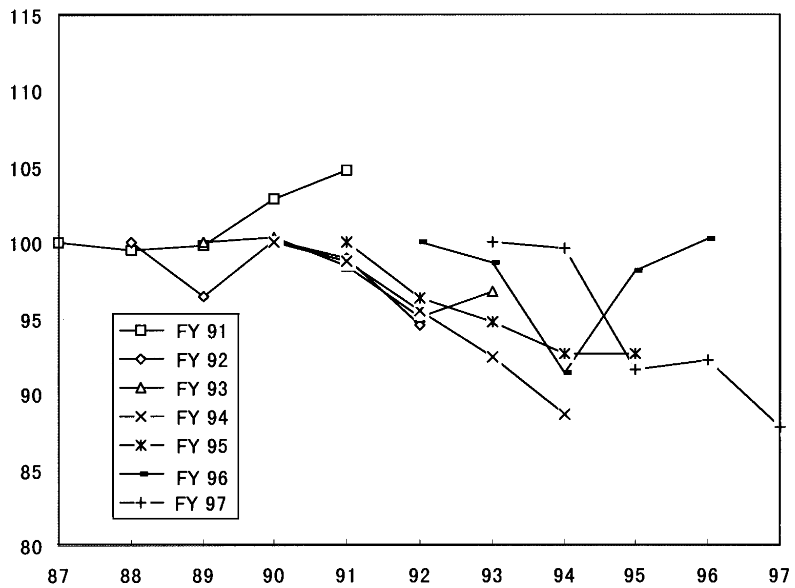
Earnings: Cross-holding continues to be reduced among companies with an ROE below the market average.

Figure 5　ROE of Formerly Cross-Held Companies



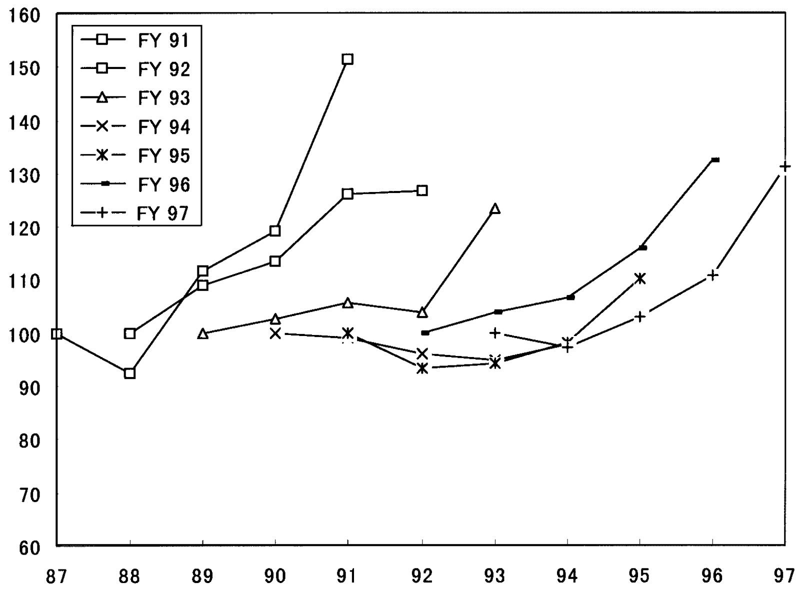
Stability: Since these companies have below-average and falling net assets per share, we can infer that their investment strategy prioritizes low-risk stocks.

Figure 6　Net Asset Value of Formerly Cross-Held Companies



Investment efficiency: Their stock prices are rising relative to the market. They are strongly aware that less cross-holding can boost returns to investors.

Figure 7　Stock Prices of Formerly Cross-Held Companies



4. Dissolution of Cross-Shareholding Through Stock Repurchases

The sale of cross-held stock generally raises a strong concern that a sudden increase in the supply of a stock will unbalance the market and push down the stock price. One solution is for the company to repurchase its stock, thereby reducing the number of outstanding shares and improving ROE and earnings per share.

While this method may work in the short term, it is not always the best long-term solution. Just as reducing cross-held stock (and other stockholdings) implies an increase in other assets (or decrease in liabilities), stock repurchases (a capital decrease) imply a decrease in assets (or increase in liabilities). For both dissolution of cross-shareholding and stock repurchase schemes, the impact on stock price will depend on whether the changes in assets and liabilities raise or lower expected returns. Presumably, stock prices are formed rationally to reflect expected returns. In any case, stock repurchases do expand the alternatives to make more efficient use of capital.

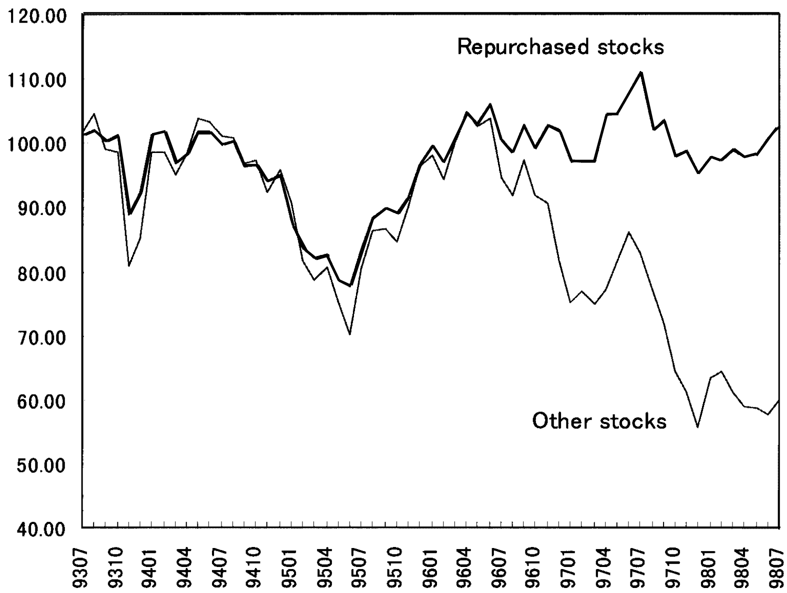
Table 4 shows the legal background to the growing acceptance of stock repurchases. There has been a marked increase in fiscal 1998 due in part to the March 1998 revision, which authorizes corporate directors to expand the available funds for repurchases until the next annual general shareholders meeting. As of the end of May, 644 companies had established stock repurchase target ranges, with the upper limit totaling 10.4 trillion yen, or 3.37 percent of total market value.

Table 4 Laws Relating to Stock Repurchase Programs

Oct. 1994	**Commercial Code revision**: By means of ordinary resolutions of regular stockholders meeting, companies can introduce stock repurchase programs funded by profits.
Nov. 1995	**Special Tax Law**: Temporary freeze on dividend tax pertaining to repurchased stock (until end of fiscal 1998).
Jun. 1997	**Amendment to Commercial Code**: Company bylaws can allow board of directors to carry out a stock repurchase by resolution.
Mar. 1998	**Amendment to Commercial Code**: Funds for stock repurchase are expanded beyond profit to capital reserves.

The companies that have announced stock repurchase programs have excelled in stock price performance (Figure 8). For the 644 listed companies announcing stock repurchase programs as of May 1998, stock prices have been indexed (end of March 1996 = 100), with the average weighted against total market value. For the other stocks, the market value weights of the 644 companies are subtracted from the TSE index (end of March 1998 = 100).

Figure 8 Price Performance of Repurchased Stocks



Furthermore, in August, Keidanren issued policy recommendations for the dissolution of cross-shareholding through direct exchange (Table 5).

Table 5 Keidanren Proposal Relating to Exchange of Cross-Held Stock

Measures under the Commercial Code

1. If the directors of publicly held companies decide to repurchase shares, stocks that have been cross-held for at least five years can be exchanged directly.
2. Exchanged stocks are to be valued at the market price.
3. Exchanged stock is to be retired without delay.

Measures under the Tax Code

For stock acquisitions by exchange, the retired stock can be charged to losses up to the amount of transfer gains at the time of exchange.

These proposals (with a time limit of approximately three years) assume a continued decline in cross-holdings and seek to minimize its impact on corporate finances and the stock market. The dissolution of cross-shareholding may be inevitable from the viewpoint of global standards as well. For example, CalPERS (California Public Employees' Retirement System) has called for as much in its principles of corporate governance for Japan. Measures to alleviate the impact on corporate finances and stock markets are also needed from the viewpoint of offering greater alternatives for efficient use of capital.