

The Accelerating Dissolution of Stock Cross-holding

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1. Introduction

The decline of stock cross-holding among companies has been attributed to many factors, including: the floundering post-bubble stock market, which has revealed the inherent risk of stockholding; stricter management accountability based on corporate governance concepts; and the shift to new financial accounting standards that require consolidated reporting and market valuation.

Our annual survey of stock cross-holding among companies listed on Japan's stock exchanges, conducted at the end of March 1999, found that companies are dissolving their stock cross-holdings at an increasingly rapid pace. This paper briefly describes the survey findings.

2. Fiscal 1998 Survey of Stock Cross-holding

(1) Changes in Survey Method

The following changes were made in the fiscal 1998 survey.

1. The source data used in our surveys — detailed tables from *yuka shoken* (Nihon Keizai Shimbunsha), and major stockholders data (Toyo Keizai Shinposha) — are revised retroactively. In the present survey, as with the fiscal 1997 and earlier surveys, revisions have been made including in the past data.

2. The definition of “financial institution” was changed from “banks excluding trust banks, and life insurance companies,” to include “non-life insurance companies.” In past surveys, the stockholdings of non-life insurance companies were considered too small to be significant in total cross-holdings. However, as cross-holdings continued to decline, the policy investments by non-life insurers became increasingly prominent, leading us to add these companies to our survey.

3. The definition of “stable holdings” was changed from “stock cross-holdings, one-sided

holdings of bank stocks by business companies, and one-sided holdings of business company stocks by financial institutions,” to also include “stockholdings in related companies.” In addition to accommodating the revised definition of financial institutions, the change was intended to increase the survey’s accuracy. With the introduction of consolidated accounting requirements in April 1999 (practical implementation of consolidation standards), companies are expected to reorganize their ties with related companies. The expanded definition of stable holdings, we believe, will yield more accurate information on the status of cross-holding from fiscal 2000.

The most recent survey, conducted at the end of fiscal year 1998 (March 1999), covered 2,426 companies with a total market value of over ¥330 trillion.

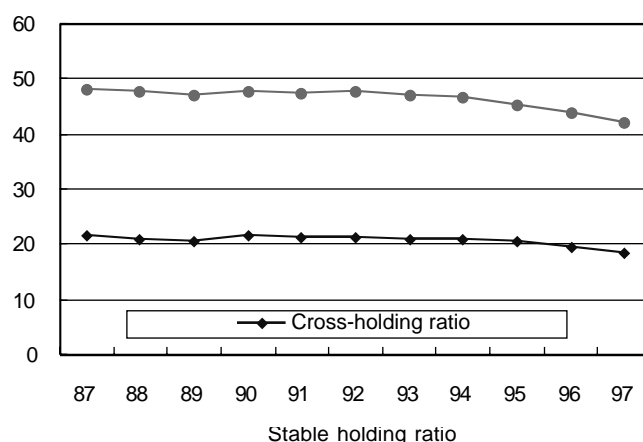
(2) Survey Results

1. Cross-holdings Decline at an Accelerating Pace

At the end of fiscal 1998, the cross-holding ratio stood at 16.02% (a 2.16% decline from the previous year), marking the eighth consecutive year of decline. The stable-holdings ratio of 41.26% (a 0.79% decline) also represents the sixth straight decline. However, the fact that the cross-holding ratio declined by more than the stable-holdings ratio suggests that some cross-holdings are being dissolved unilaterally; that is, one party in the cross-holding arrangement retains its holdings.

The same picture appears from the perspective of stock counts: the cross-holding ratio is 15.39% (1.01% decline), and the stable holding ratio is 38.22% (1.37% decline). These are the lowest levels since the survey was begun in fiscal 1987 (Figure 1).

Figure 1 Cross-holding and Stable-holding Ratios (end of FY, %)



Source: NLI Research Institute

Table 1 Cross-holding Ratio by Stockholder Type

Fiscal year	Overall cross-holding ratio	By business co.		By bank	
		Business co.	Bank	Business co.	Bank
87	21.47	4.1	6.68	6.22	0.43
88	21	4.35	5.99	6.69	0.38
89	20.3	4.74	5.51	6.76	0.32
90	21.42	4.82	5.9	7.18	0.38
91	21.32	4.87	5.68	7.3	0.42
92	21.21	4.74	6.02	7.18	0.38
93	20.77	4.65	5.84	7.03	0.36
94	20.7	4.75	5.66	7.07	0.37
95	20.31	4.85	5.36	6.98	0.33
96	19.52	4.97	4.17	7.69	0.22
97	18.19	4.71	3.51	7.53	0.11
98	16.02	4.26	3.19	6.51	0.04

Source: NLI Research Institute

2. The Cause of the Declining Cross-holding Ratio: Sale of Business Company Stocks by Financial Institutions

Table 1 breaks down cross-holding ratios by stockholder. It shows that while business companies reduced their cross-held bank stocks by 0.32%, banks sold off 1.02% of their cross-held stock in business companies. The decline in cross-holding began in earnest in fiscal 1996 when business companies sold their bank stocks. In fiscal 1998, the decline progressed as banks sold their stock in business companies.

Unlike financial institutions, whose unrealized gains have plunged and stockholding has become undesirable from the perspective of risk management, business companies are expected to ease up their dissolution of cross-holdings for the following reasons: (1) concern over falling stock prices has ebbed, (2) the recent deterioration in business performance has reduced their capacity to dissolve cross-holdings, and (3) stockholdings at most companies large unrealized gains (Table 2).

Table 2 Factors Affecting the Dissolution of Cross-holdings at Business Companies

Fiscal year	Cross-holding ratio (yoy change)		ROI (3-year avg.)	Earnings growth in manufact.	Unrealized gains from stock	
					No. of cos. (% total)	Gains
87	12.97%	(-0.85%)	0.4%	49.2%	963 (97.9%)	· 67.03 tr
88	12.13%	(-0.84%)	32.9%	26.6%	985 (98.2%)	· 73.52 tr
89	11.68%	(-0.45%)	27.1%	11.0%	1000 (97.4%)	· 66.41 tr
90	12.26%	(0.58%)	5.7%	-3.8%	1022 (97.2%)	· 59.23 tr
91	11.94%	(-0.28%)	-3.0%	-16.7%	943 (87.5%)	· 36.97 tr
92	11.98%	(0.04%)	-17.5%	-34.0%	979 (90.5%)	· 36.88 tr
93	11.78%	(-0.20%)	-8.8%	-19.6%	1017 (93.6%)	· 42.78 tr
94	11.63%	(-0.15%)	-2.8%	30.2%	945 (86.9%)	· 32.31 tr
95	11.37%	(-0.26%)	2.0%	19.3%	1050 (94.5%)	· 44.09 tr
96	10.06%	(-1.31%)	3.2%	21.3%	949 (83.1%)	· 30.37 tr
97	9.08%	(-0.94%)	-2.5%	-1.9%	888 (75.3%)	· 24.87 tr
98	8.05%	(-1.03%)	-3.0%	-32.1%	978 (82.1%)	· 32.98 tr

Source: NLI Research Institute

3. Buyers of Formerly Cross-held Stock

Table 3 describes the buyers of stock from dissolved cross-holdings. As before, they are mainly pension funds and foreign investors. But as we mentioned earlier, the fiscal 1998 survey revealed that some stock was being absorbed into stable holdings, suggesting that business companies continue to hold their financial stocks even as financial institutions dispose of their holdings in business companies.

Similar to the previous year, in terms of stock volume, individual investors were also major purchasers of formerly cross-held stocks. Since these acquisitions are assumed to have replaced other holdings, the absorption of formerly cross-held stock appears to retain a dual structured characteristic consisting of funding source and stockholding.

Table 3 Destination of Formerly Cross-held Stock

FY	Change in cross-holding ratio	Other stable stockholdings	Other corporate holdings	Pension trust	Individual	Foreigner
88	-0.47%	0.29 (+1.85)	0.04 (+1.22)	-0.03 (+0.09)	-0.46 (+0.06)	0.21 (+0.73)
89	-0.7	-0.22 (+1.34)	0.15 (+0.60)	-0.12 (-0.05)	0.58 (+1.18)	-0.14 (+0.04)
90	1.12	-0.37 (+0.35)	-1.19 (-0.59)	0 (+0.01)	-0.13 (+1.00)	0.5 (+0.46)
91	-0.1	0.03 (+0.41)	-1.12 (-0.13)	0.12 (+0.16)	-0.05 (+0.66)	1.35 (+1.51)
92	-0.11	0.23 (+0.46)	-0.79 (-0.23)	0.14 (+0.15)	0.41 (+0.94)	0.28 (+0.28)
93	-0.44	-0.15 (+0.19)	-0.1 (+0.64)	0.24 (+0.31)	-0.67 (+0.47)	1.4 (+1.55)
94	-0.07	-0.23 (+0.72)	0.09 (+1.24)	0.22 (+0.27)	-0.15 (+0.71)	0.39 (+1.26)
95	-0.39	-1.15 (-0.43)	-0.23 (+0.47)	0.18 (+0.24)	-0.39 (+0.65)	2.4 (+2.47)
96	-0.79	-0.62 (+0.48)	-0.22 (+0.78)	0.6 (+0.68)	-0.12 (+0.87)	1.43 (+0.91)
97	-1.33	-0.36 (-0.04)	-0.34 (+0.88)	1.42 (+1.10)	-0.39 (+1.60)	1.41 (+0.41)
98	-2.17	1.39 (+0.58)	-0.45 (+0.89)	0.9 (+0.83)	-0.12 (+1.35)	0.73 (+0.85)

Note: Numbers in parentheses denote effect of number of shares held, which is calculated as follows.

$$\frac{n \times p}{M} - \frac{n(-1) \times p(-1)}{M(-1)} = \frac{(n(-1)+n) \times (p(-1)+p)}{M(-1)+M} - \frac{n(-1) \times p(-1)}{M(-1)}$$

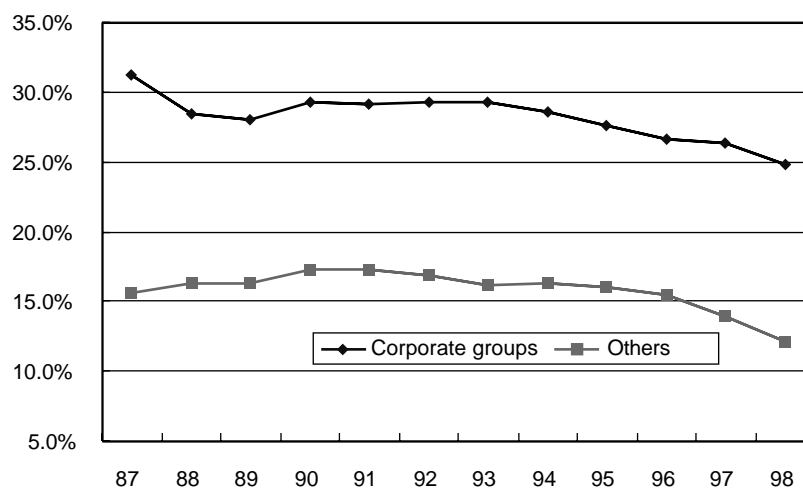
$$= \frac{(-1) \times p(-1)}{M(-1)+M} - \frac{n(-1) \times p(-1)}{M(-1)} + \frac{n \times p(-1)+p \times n(-1)+n \times p}{M(-1)+M}$$

$$= \underbrace{\frac{n \times p(-1)}{M(-1)}}_{\text{Effects of: No. of shares}} + \underbrace{\frac{p \times n(-1)}{M(-1)}}_{\text{Stock price}} + \underbrace{R}_{\text{Other}}$$

4. Behavior of Corporate Groups

Cross-holding ratios among corporate groups also continue to decline. However, compared to non-group companies, group companies continue to demonstrate strong cross-holding ties (Figure 2).

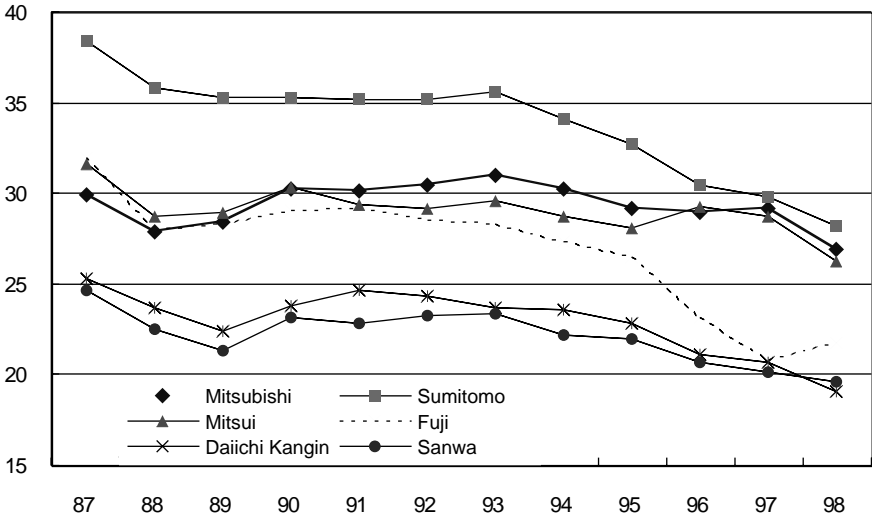
Figure 2 Cross-holding Ratio of Corporate Groups (%)



Source: NLI Research Institute

Moreover, in fiscal 1998 cross-holding ratios continued to decline among companies in former zaibatsu groups (Mitsubishi, Sumitomo, and Mitsui), while companies in bank-centered groups (Fuji, Daiichi Kangyo, and Sanwa) are characterized by rising ratios (Figure 3).

Figure 3 Cross-holding Ratios of Various Corporate Groups (%)



Source: NLI Research Institute

3. Effects of the Dissolution of Cross-holdings

(1) Persistence of the Cross-holding Structure

Even as cross-holding and stable-holding ratios continue to decline, it remains unclear whether the stock cross-holding structure itself is waning. Table 4 shows the cross-holding status of the companies surveyed. Despite edging down, the proportion of companies with confirmed cross-holdings still remains above 95%. On the other hand, while the proportion of companies without confirmed cross-holdings has increased, their total number remains small. These findings attest to the important role that cross-holding plays in Japan's corporate system.

Table 4 Number of Companies with Confirmed Stock Cross-holdings

FY	No. companies surveyed	Cross-holding confirmed	Business companies	Banks	Companies without cross-holding
87	1,924	1,827 (95.0%)	(95.8%)	(80.6%)	74 (3.8%)
88	1,975	1,894 (95.9%)	(96.7%)	(83.8%)	59 (2.9%)
89	2,030	1,951 (96.1%)	(97.1%)	(84.9%)	59 (2.9%)
90	2,078	1,999 (96.2%)	(97.2%)	(85.3%)	59 (2.8%)
91	2,106	2,032 (96.5%)	(97.2%)	(88.9%)	58 (2.7%)
92	2,120	2,052 (96.8%)	(97.5%)	(89.9%)	54 (2.5%)
93	2,161	2,095 (96.9%)	(97.5%)	(91.8%)	56 (2.5%)
94	2,211	2,141 (96.8%)	(97.2%)	(93.6%)	59 (2.6%)
95	2,277	2,201 (96.7%)	(96.9%)	(94.4%)	67 (2.9%)
96	2,339	2,257 (96.5%)	(96.9%)	(92.7%)	72 (3.0%)
97	2,387	2,290 (95.9%)	(96.3%)	(92.7%)	90 (3.7%)
98	2,426	2,309 (95.2%)	(95.3%)	(96.2%)	113 (4.6%)

Note: For business companies and banks, numbers denote percentage of confirmed companies within each category.

Source: NLI Research Institute

(2) Impact on the Stability of Management Rights

The decline in cross-holding and stable-holding ratios appears to be affecting the original cross-holding objective of stabilizing management rights through, among other things, an increase in the stockholding ratio of foreign investors.

Table 5 describes some practical indicators of the stability of management rights such as the operation of annual general meetings. In general, to ensure a smooth AGM, companies secure at least half of stockholders in attendance, and at least two-thirds of attending stockholders who vote with management. However, as Table 6 shows, the stockholding ratio of foreign investors has grown to the point of being difficult to ignore. This has resulted in the resurgence of cross-holding among some regional banks and business companies. On the other hand, companies with a high proportion of foreign investors (excluding those that foreign companies have acquired management rights) tend to strive toward global standards with respect to returns, IR (investor relations) activities, and an emphasis on stockholder interests. These trends suggest a correlation between the dissolution of cross-holdings and emphasis on stockholders interests.

Table 5 Provisions in the Commercial Code Regarding Stockholders Rights

<p>Article 239 Voting procedure at annual general meeting</p> <p>Unless otherwise stipulated in the articles of incorporation, a quorum shall consist of stockholders in attendance who own over half of the outstanding stock, and resolutions shall be decided by majority vote.</p> <p>Article 245 Transfer of business</p> <p>For the company to engage in the activities listed, it must comply with the resolution stipulated in Article 343.</p> <p>Article 256-2 Election of executives</p> <p>With regard to the election of executives, stockholders in attendance at the AGM must own the number of stocks stipulated in the Articles of Incorporation, which must be no less than one-third of outstanding stock.</p> <p>Article 343 Revision of Articles of Incorporation</p> <p>The resolution in Clause 1 of the preceding article, a quorum shall consist of stockholders in attendance who own the majority of outstanding stock, and shall require at least two-thirds of the vote.</p>

FY	Stockholding ratio of foreigners (business companies on TSE 1st section)						Companies in which stockholding ratio of foreigners by net investment exceeds 33%
	Total no. companies	50% -	33% -	10% -	3% -	1% -	
88	977	9	13	87	434	739	
89	1,002	11	13	78	470	817	
90	1,028	10	12	95	441	787	
91	1,057	9	12	144	531	818	
92	1,064	9	12	149	528	804	
93	1,074	10	13	198	630	870	Aoyama Trading
94	1,080	10	12	235	682	920	
95	1,104	11	19	322	728	944	Aoyama Trading, Rohm, Canon Inc., Orix Corp., Sony Corp., Omron Corp.
96	1,141	11	23	335	741	979	Rohm, Aoyama Trading, Canon Inc., Sony Corp., Fuji Photo Film, Murata Mfg., TDK Corp., Orix Corp.
97	1,187	13	26	321	708	980	Sony Corp., Aoyama Trading, Rohm, Canon Inc., Minebea, Murata Mfg., Fuji Photo Film, Orix Corp., TDK Corp.
98	1,208	13	30	300	675	916	Sony Corp., Rohm, Murata Mfg., Aoyama Trading, Canon Inc., Fuji Photo Film, Suzuki Motor Corp., Yamanouchi Pharmaceutical, Orix Corp., TDP Corp., Tokyo Electron

Table 6 Ratio of Foreign Stockholdings

Source: NLI Research Institute

(3) Effect of Stock Prices

Many market participants firmly believe — particularly when the stock market is in a downturn — that the dissolution of cross-held and stable stockholdings is partly to blame for the market’s poor performance. According to this logic, the sudden release of a substantial number of stocks into the market supposedly upsets the market balance and depresses stock prices.

However, this concern focuses only on the supply of stocks and ignores how the proceeds from stock sales are reinvested. Theoretically, aside from short-term effects, the dissolution of cross-holdings is a neutral factor. Its impact on stock prices will depend on whether the returns of the cross-held stock are higher than the expected returns of the new investments.

Figure 4 looks at the effect of dissolution by comparing the stock prices of companies that have reduced their cross-holdings and those that have not. As of 1990, stock prices are higher for companies that have reduced their cross-holdings. Recently, however, this tendency has reversed, confirming that the dissolution of cross-holdings does not put downward pressure on stock prices.

In the past, measures considered to absorb formerly cross-held stock included institutional arrangements and pension expenditures to bolster reserves, some of which were implemented. Interest in this issue has waned recently due in part to the stock market's nascent recovery. But the fact remains that stock cross-holdings are in decline. Thus we need to look beyond measures directed at stock prices and consider how the corporate system can construct and maintain ways to ensure the stability of management rights.

