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Ownership structure and firm profitability in the Japanese keiretsu

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Abstract

Financial institutions within Japan's corporate groups, called keiretsu, are both lenders and shareholders of member firms. Current literature has failed to produce unanimity about how ownership of firms by financial institutions affects firm profitability. Competing theories propose that banks use this position as shareholder either to promote firm profitability, or to increase lending to generate interest revenue. This paper uses panel data to show that bank ownership results in profit non-maximization if the bank simultaneously holds debt in the firm. It is also shown that, despite continuing financial deregulation, the significance of ownership integration within the keiretsu has remained unchanged.

JEL classification: G32; L22

Keywords: Keiretsu; Japanese firms; Firm ownership; Vertical integration

1. Introduction

The unique ownership structure within the Japanese keiretsu has been the subject of a great volume of literature. Despite its abundance, this literature has failed to produce unanimity about the relationship between keiretsu ownership structure and its effects on member firm performance. Proposed theories generally take one of two perspectives. The first states that ownership ties between keiretsu firms and a Main Bank (as well as inter-firm

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ownership ties) serve to increase the level of monitoring of a firm's management. This, in addition to providing member firms with greater access to capital than non-member firms, should result in a positive relationship between ownership concentration and profitability. The opposing argument states that the Main Bank relationship encourages firms to "overborrow", which increases interest revenue for banks but hinders firm performance. Banks may also use their shareholding position to pressure firms to maximize sales as opposed to maximizing profits, which is intended to increase returns on loans. If the latter argument prevails, then we should observe a negative relationship between the degree of ownership and profitability.

This paper attempts to answer this question by examining the relationship between ownership structure of keiretsu firms and profitability. Specifically, does the role of the Main Bank as a shareholder dominate its role as a lender, or would the bank rather sacrifice firm profitability for an increase in interest revenue? If the latter is true, this implies that the bank uses its position as a shareholder to manipulate management in ways that are inconsistent with share price maximization. We try to explain what might justify such behavior, despite the fact that banks are shareholders and thus should want to see share price maximized. This paper will also estimate how the relationship between bank ownership and firm profitability has changed during the 1990s in light of deregulation measures within Japanese financial markets.

The remainder of this paper is as follows. Section 2 will present a brief history of the keiretsu and show how these corporate groups have formed from the predecessor zaibatsu. Section 3 examines the differences between the United States and Japan in terms of information structures within the firm. It will be shown that much of the difference between these two systems can be credited to the unique ownership structure within the keiretsu, which is examined in detail in Section 4. Section 5 examines the effects of ownership integration between banks and firms, and outlines the dual role of the Main Bank as both a lender and as a shareholder. The existence of these two distinct roles creates ambiguity about the effect between the Main Bank relationship and profitability, which is modeled in Section 6. This modeled relationship will be empirically tested in Section 7, and we will examine financial market deregulation in Japan since 1984 and test its effect on the importance of the Main Bank relationship in Section 8. Finally, Section 9 will present a conclusion and propose potential topics for future study.

2. Formation of the keiretsu

2.1. *The zaibatsu*

The zaibatsu were large, family controlled conglomerates that dominated the prewar Japanese economy, controlling over 25% of all capital assets. There were 14 main zaibatsu families, but the largest and most prosperous were Mitsui, Mitsubishi, Sumitomo and Yasuda.[1]

[1] The remaining 10 zaibatsu were Ayukawa, Asano, Furukawa, Kawasaki, Matsushita, Nakajima, Nomura, Okochi, Okura and Shibusawa. Mitsui, Mitsubishi, Sumitomo and Yasuda continued through the post-war keiretsu, although the Yasuda group name was changed to the Fuyo group.