Finding Key Investors to Take Over from Cross-Shareholders

Masahiko Igata
Senior Managing Director,
Nomura Institute of Capital Markets Research

Hiroshi Yoshikawa
Research Associate,
Nomura Institute of Capital Markets Research

I. Three factors that could further erode cross-shareholdings

In Japan, it has been the custom for many years for financial institutions and business partners to hold strategic stakes ("cross-shareholdings") in nonfinancial companies ("companies"). Although these cross-shareholdings have been eroded since the asset boom of the 1980s turned to bust in the 1990s, we note a number of changes that could accelerate this process.

1. Global moves towards tightening regulations on financial institutions

As a result of the recent financial crisis, there have been moves, especially by the G20 countries, to tighten regulations governing financial institutions (Figure 1). The main moves that could affect the shareholdings of Japanese financial institutions are (1) tighter rules on regulatory capital, (2) the introduction of a leverage ratio requirement, and (3) tighter rules on trading books.

In our view, the most important development as regards tighter regulation of regulatory capital is the prospect of much more stringent rules on double gearing[1]. The aim, motivated by the recent financial crisis, is to sever the ties between financial institutions ("interconnectedness") and make them more resistant to such crises. It is also now standard practice in Japan, when, for example, financial institutions take stakes in each other, for these cross-shareholdings to be deducted from their regulatory capital when calculating their capital adequacy ratios. What is now being proposed, however, is that these restrictions should be extended from stakes in other Japanese financial institutions to stakes in non-Japanese institutions and even stakes acquired on the secondary market. If such stakes were to be widely deducted from

[1] For further details of the proposals to tighten the rules governing banks (including the rules on double gearing), see Kodachi, Kei, "Baazeru Iinkai ni Yoru Aratana Ginkou Kisei Kyoukaan" (Tough New Banking Rule Proposals from the Basel Committee), *Capital Markets Quarterly*, Winter 2010 (in Japanese).

financial institutions' regulatory capital, financial institutions' capacity to retain such stakes would inevitably be impaired.

Figure 1: Global moves to tighten regulations governing financial institutions, especially in the G20 countries

- Discussions on tightening rules on regulatory capital → Improving quality of capital, increasing minimum required capital ratio, introducing capital buffer

<Main points>
- Improving the quality of capital: this is the argument that Tier 1 capital should consist mainly of common stock (with voting rights) and retained earnings. Discussions have also been tending towards tightening the rules on double gearing considerably.
  - Should preferred stock be included in Core Tier 1? How should preferential participation certificates and deferred tax assets be treated?
- Increasing the minimum required capital ratio: what percentage should it be raised to?
  - The UK Financial Services Authority has already ruled that the minimum "Core Tier 1 ratio," consisting solely of common stock and retained earnings, should be 4%. Furthermore, the *Turner Review* proposed that the minimum "Tier 1 ratio" should be 8%.
- Introducing a capital buffer: what level should this be topped up to during good times?
  - The *Turner Review* implies that the capital adequacy ratio should be increased by 2–3% at the peak of the business cycle.

✓ Financial institutions need to boost margins if they are to accumulate retained earnings
✓ Will some institutions need to raise more capital

- Introducing rules on leverage → Boosting regulatory capital, also possible need to reduce assets (liabilities)
- Tightening rules on trading books → regulatory capital needed for trading may have to be increased

⇒ Financial institutions' capacity to own shares may generally be reduced by their need for retained earnings and to reduce their assets in order to raise their capital adequacy ratios and improve the quality of their capital

Source: Nomura Institute of Capital Markets Research.

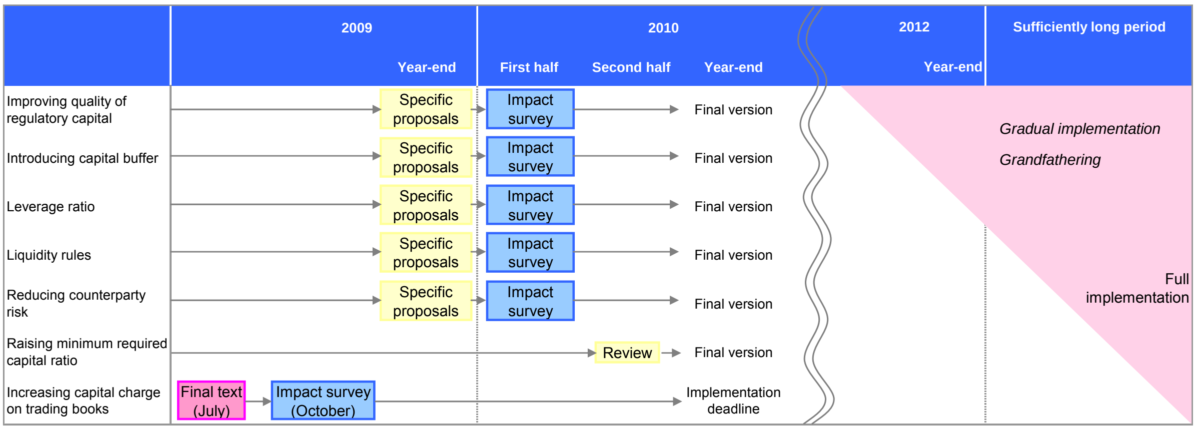
Further measures include (1) calls for more importance to be attached to retained earnings and common stock in order to raise the quality of financial institutions' regulatory capital base, (2) the introduction of a capital buffer, and (3) an increase in the minimum required capital ratio. This would mean that financial institutions would have to become more profitable in order to increase their retained earnings. We would expect repeated capital increases to be subject to considerable restrictions in some cases.

The introduction of a leverage ratio requirement would require financial institutions to either increase their capital or reduce their assets (liabilities). Tighter rules on trading books would require more capital for trading operations. In a quantitative impact survey (QIS) published in October 2009, the Basel Committee found that capital would have to increase by an average of 2-3 times.

Major Japanese banks have been selling large amounts of equities every year in order to comply with the higher risk weights for equity positions that come into effect in July 2014 as a result of Basel II. We think that, if the measures that have been proposed are gradually implemented (Figure 2), the need for banks and other financial institutions to increase their retained earnings and reduce their assets will reduce their capacity to remain invested in equities and possibly lead them to sell their equity positions at an even faster rate. We have already seen developments such as selling of regional bank shares by major Japanese banks and announcements by these banks that they will lower the ratio of their equity holdings to their core capital[2].

2 See the press release by Shizuoka Bank (http://www.shizuokabank.co.jp/pdf.php?id=557) and the 9 January 2010 morning edition of the *Nikkei*.

Figure 2: Timetable for implementation of new rules



Source: Nomura Institute of Capital Markets Research.

2. Moves by the Financial Services Agency towards regulating cross-shareholdings

In addition to global moves to tighten rules on financial institutions, there have been proposals in Japan that banks should be required to disclose details of their shareholdings (Figure 3). As a result of the *Shareholdings Restriction Law*, Japanese banks' equity holdings have been limited since September 2006 to the value of their Tier 1 capital. Despite this, at a meeting on 10 June 2009, the Financial System Council's Study Group on the Internationalization of Japanese Financial Markets and Capital Markets pointed out the structural risk that Japanese banks' capital adequacy ratios and their willingness to lend would suffer if the value of their cross-shareholdings declined. Some of the participants therefore recommended that, although some companies already disclose details of their cross-shareholdings, serious consideration should be given to making this a requirement as soon as possible. Similarly, some suggested that the FSA would make it easier for banks to dispose of their cross-shareholdings if it introduced a rule banning such shareholdings. Some recommended that such a rule should impose a stricter limit (e.g., 50% of regulatory capital) in order to induce banks to reduce such shareholdings as much as possible. In response, the FSA indicated that it wanted banks to make as much use as possible of the opportunity to sell their shareholdings to the Banks' Shareholdings Purchase Corporation while this was still available. However, there is little time left for the banks to do this as the window of opportunity is due to shut in April[3].

Finally, it is perhaps worth mentioning in this context that, in the FSA's *Comprehensive Guidelines for Supervision of Major Banks* (December 2009), there is a footnote that restricting the banks' shareholdings should help to restructure and revitalize the Japanese stock market by reducing cross-shareholdings and help to

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3 The Banks' Shareholdings Purchase Corporation can sell the shares it has purchased at any time until end-March 2022.

revitalize the Japanese economy by improving corporate governance—as well as improve the banks' finances and risk management[4].

Figure 3: Recent views and developments concerning cross-shareholdings

- Financial System Council's Study Group on the Internationalization of Japanese Financial Markets and Capital Markets meets (since 10 June 2009)
  - Bank cross-shareholdings give rise to the problem of capital adequacy and lead to credit crunch (structural problem)
  - Banks should be required to disclose details of their cross-shareholdings
  - Need to either prohibit banks from cross-shareholding or to set a target for them to dispose of their cross-shareholdings
  - Banks' Shareholdings Purchase Corporation resumes purchases of shares and will hopefully do so aggressively

- Financial Services Agency is considering whether to require banks to disclose details of their cross-shareholdings in their securities filings (according to press conference with FSA commissioner)

- Financial Services Agency's *Comprehensive Guidelines for Supervision of Major Banks* (December 2009)
  - Restricting banks' shareholdings will help to restructure and revitalize the Japanese stock market by reducing cross-shareholdings and help to revitalize the Japanese economy by improving corporate governance—as well as improve the banks' finances and risk management (Market Risk Management III-2-3-3)

Source: Nomura Institute of Capital Markets Research.

3. Moves to introduce International Financial Reporting Standards (IFRS)

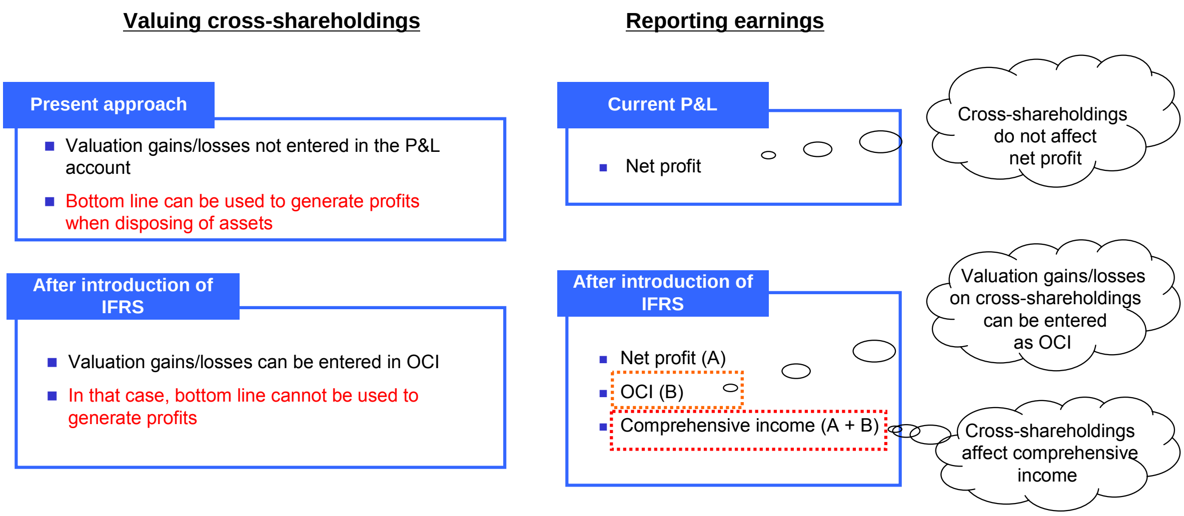
Japanese financial institutions may be obliged to adopt IFRS in 2015-16. The final standard in the first part of IFRS 9 *Financial Instruments*, issued on 12 November 2009, divides all financial assets that are currently in the scope of IAS 39 into just two classifications: those measured at amortized cost and those measured at fair value.

Equity investments within the scope of IFRS 9 are to be measured at fair value in the balance sheet, with value changes recognized in profit or loss each fiscal year (Figure 4). By way of exception, however, changes in the value of cross-shareholdings may be reported in "other comprehensive income" (OCI). In that case,

4 In this connection it is perhaps worth quoting the following remarks by Mr Takafumi Sato (former commissioner of Japan's Financial Services Agency) at a press conference on 6 July 2009: "We are encouraging the banks to improve how they manage the risk of owning equities and leaving it largely up to each to decide whether or not to reduce its shareholdings. At the same time, the Banks' Shareholdings Purchase Corporation is ready to act as a safety net." … "For the time being we are leaving it to individual banks to deal with this and will continue to monitor whether they are managing their risks properly." … "We will continue to consider whether to require the banks to disclose details of their cross-shareholdings (e.g., in their securities filings) and continue discussions about this with market participants. At the same time, we will take these recommendations (by the Financial System Council) into account." It has also been reported (in the 5 July 2009 morning edition of the *Nikkei*) that the Financial Services Agency intends to require listed companies to disclose details (namely, reason for ownership and size of holding) of their cross-shareholdings.

capital gains cannot be reported in profit or loss. In other words, the bottom line cannot be used to generate profits. However, even if changes in the value of cross-shareholdings are reported in other comprehensive income, comprehensive income can fluctuate as a result of such changes.

Figure 4: Moves to introduce International Financial Reporting Standards (IFRS) in Japan



Source: Nomura Institute of Capital Markets Research, based on IASB and other data.

Because comprehensive income will be reported in the comprehensive income statement once IFRS 9 is adopted and cross-shareholdings will affect comprehensive income, this may give financial institutions and companies yet another reason to dispose of these shareholdings. This may be borne out by reports we have seen that companies have been selling their bank shareholdings—possibly because they need to dispose of their cross-shareholdings[5]. We have also seen reports that companies have been selling their shareholdings in other nonfinancial companies. According to one such report, the value of the cross-shareholdings reported in the securities filings of 22 of the 29 companies in the Mitsubishi Group declined by 40% to ¥2.2 trillion from end-March 2008 to end-March 2009[6].

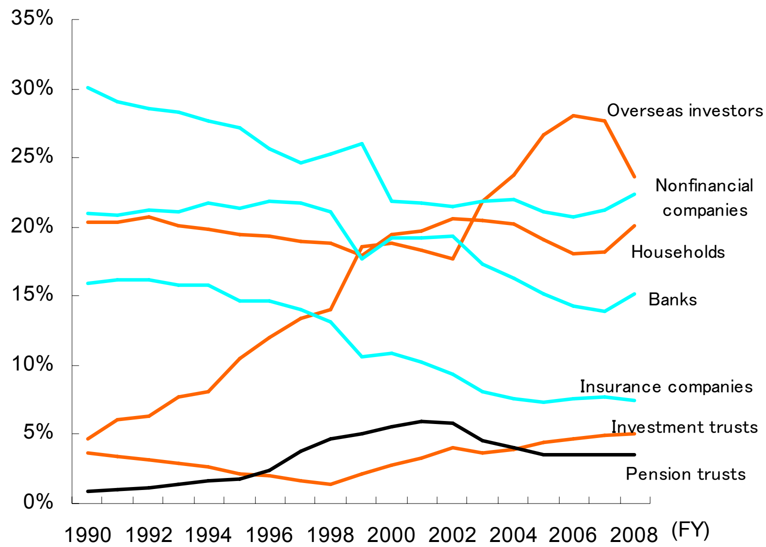
5 See 9 January 2010 morning edition of the *Nikkei*.

6 See 15 January 2010 morning edition of the *Nikkei*. According to the article, one of the group companies, Kirin Holdings, intends to sell most of its holdings in the group's 29 companies (worth several tens of billions of yen) over the next three years.

II. Finding investors to take over from cross-shareholders

As we have seen, the disposal by financial institutions and nonfinancial companies of their cross-shareholdings, which has been a medium- to long-term trend, could accelerate as a result of the changes they face. As we can see from Figure 5 (a breakdown of share ownership on the Tokyo Stock Exchange by type of investor), households, pension trusts, investment trusts and nonresident investors assume an increasingly important role as the capacity of nonfinancial companies, banks and insurance companies to retain their shareholdings looks like diminishing.

Figure 5: Share ownership by type of investor



Source: Nomura Institute of Capital Markets Research, based on Tokyo Stock Exchange's *Share Ownership Survey.*

1. Persuading households to invest in equities

1) More and continued tax perks for individuals

In December, the government agreed the outline of the tax reforms for fiscal 2010, including tax exemptions on capital gains and dividend income from small investments ("Japanese ISAs")[7]. As the unwinding of cross-shareholdings has gathered momentum, it is even more important that retail investors be encouraged to invest more in equities over the long term. This may well mean, for example, making the tax reductions on capital gains and dividend income from equity investment permanent measures[8].

7 See the section of the Financial Services Agency's website on tax reform (http://www.mof.go.jp/jouhou/syuzei/syuzei04.htm) (in Japanese).

8 See *Nikkei* interview with president of Nomura Holdings, Ken'ichi Watanabe (5 January 2010).

2) Improving retail investor relations and using direct stock purchase plans

Companies also need to make a greater effort to cultivate their relations with retail investors. This is because investor relations are one of the main ways in which companies can persuade retail investors to become long-term shareholders. Also, one of the ways in which retail investors in the US can buy shares easily is by means of direct stock purchase plans (DSPs). These enable retail investors to buy stocks (including odd lots) directly from a company for a fixed amount of money. Many US companies have set up such plans, and they are often referred to in investment guides aimed at retail investors[9]. We think Japanese companies should consider them as a way of widening their retail shareholder base.

3) The use of ESOPs by US companies seeking to restructure

Another way in which individuals can own shares is as employees of companies with employee stock ownership plans (ESOPs). These are widespread in the US. Companies with such plans contribute money to accumulate treasury stock on behalf of their employees[10]. Such plans are often compared to similar schemes in Japan. In Japan, however, these schemes are "opt-in" (i.e., membership is optional), whereas in the US they are "opt-out" (i.e., an employee is considered a member unless he expresses a wish to the contrary). The idea is that employees will benefit directly from any increase in enterprise value and that this will act as an incentive.

In the US there have been cases where companies seeking to restructure have set up ESOPs as a way for management and employees to work towards a common goal[11]. For example, in the 1970s Chrysler's earnings deteriorated rapidly in the face of Japanese competition and as its inventories of unsold vehicles piled up as a result of its pursuit of volume sales. The company's response was to try to restructure by cutting costs (including wages); but, in exchange for loan guarantees from the US administration and Congress, it agreed to set up an ESOP to boost employee morale and raise productivity (Chapter 7 of Chrysler Corporation Loan Guarantee Act of 1979). When the company's earnings improved and the share price recovered in the early 1980s, the employees benefited considerably via their ESOPs.

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9 See the SEC's website (http://www.sec.gov/answers/drip.htm); Yanagiya, Takashi (trans.) *Yutori Aru Mai Sekando Raifu* (Enjoying One's Second Life in Comfort), Toyo Keizai Inc. (2004), p.74 (in Japanese); and Watanabe, Ken'ichi (trans.), *Josei no Tame no Toushi Sensuappu Gaido* (A Woman's Guide to Honing One's Investment Skills) (2005), p.36 (in Japanese).

10 For more on ESOPs, see Igata, Masahiko (et al.), "*Beikoku ESOP no Gaiyou to Wagakuni e no Dounyuu*" (The Role of ESOPs in the US and Their Introduction in Japan), *Capital Markets Quarterly*, Spring 2001 (in Japanese); Nomura, Akiko, "*Beikoku Koukai Kigyou ni Yoru ESOP no Katsuyou to Wagakuni e no Shisa*" (The Use of ESOPs by Public Companies in the US and Some Possible Lessons for Japan), *Capital Markets Quarterly*, Winter 2006 (in Japanese); and Nomura, Akiko, "*Beikoku ni Okeru Rebarejjido ESOP no Jigyou Keishou e no Katsuyou*" (The Use of Leveraged ESOPs for Business Succession in the US), *Capital Markets Quarterly*, Spring 2006 (in Japanese).

11 For more on the use of ESOPs in corporate restructuring, see Igata, Masahiko (et al.), "*Beikoku ESOP no Gaiyou to Wagakuni e no Dounyuu*" (The Role of ESOPs in the US and Their Introduction in Japan), *Capital Markets Quarterly*, Spring 2001 (in Japanese).

Similarly, when United Airlines (UAL)'s earnings fell sharply in the early 1990s as a result of price competition created by deregulation, it had no option but to trim employee benefits in order to improve its cost structure. In exchange for accepting this, however, the employees demanded that the company set up an ESOP allowing them to become major shareholders (with 55% of the voting rights). The company agreed to the request. UAL's earnings began to recover in 1994, a development which the company attributed in its annual report to its introduction of an ESOP[12].

ESOPs modeled on those in the US have also been set up by Japanese companies within the existing legal framework[13].

4) Advantages to Japanese companies of Japanese-style ESOPs

We think there are lessons to be learnt by Japanese companies from the experience of major US companies of using ESOPs to boost employee morale during restructuring.

Aggregate earnings results for stocks listed on the Tokyo Stock Exchange show that corporate earnings fell sharply as a result of the financial crisis. Aggregate operating profit for FY08 fell 53% year-on-year to ¥17 trillion, while net profits fell 99% to ¥203.8 billion (Figure 6). Many companies have been cutting costs in response to lower sales and profits, and employment costs are unlikely to be an exception. Private-sector cash wages declined from 99.9 in 2008 (2005 = 100) to 89.1 in 2009 (average for Jan-Oct). Also, the percentage of companies that either have cut or are planning to cut wages has risen from 9.3% to 30.9%. This suggests to us that it is now more important than ever to offer employees incentives and to ensure that they are motivated.

Companies must make their shares more attractive to potential shareholders (who might absorb some of the cross-shareholdings that are being unwound) by becoming more profitable. In particular, companies looking to achieve better results might find ESOPs a good way to enable their employees to own their shares and to induce management and employees to work towards a common goal. Also, by becoming shareholders, employees would send a signal to other shareholders that they (the employee-shareholders) had an incentive to increase the company's profitability.

As we mentioned above, Japan already has its own type of ESOP, based on the US model. The main aim of Japanese ESOPs is to give employees a long-term incentive and to use this as a selling point for the shares of the companies concerned. However, the fact that companies could use ESOPs to acquire relatively large amounts of treasury stock in advance by means of the trust means that companies could also use them to absorb shares that would otherwise be released into the market as a result of the unwinding of cross-shareholdings.

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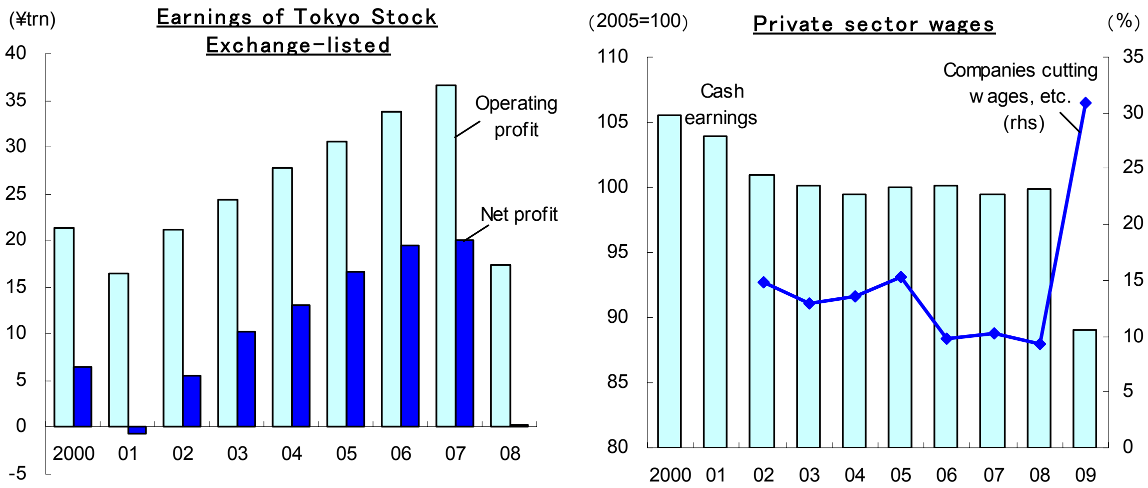
12 However, the company filed for Chapter 11 bankruptcy in 2002 as a result of the negative impact of 9/11 on its earnings.

13 For more on ESOPs in Japan, see Hashimoto, Motomi, "*Nihonban ESOP (Juugyouin Jishakabu Hoyuuseido) no Toujou to Sono Yakuwari*" (The Emergence and Role of ESOPs in Japan), *Zaikai Kansoku*, Autumn 2009.

In view of the risk that the rate at which cross-shareholdings are being unwound in Japan could increase, we think many Japanese companies should consider setting up an ESOP.

Figure 6: Japanese corporate earnings and employee wages



Note: 1. Earnings of Tokyo Stock Exchange-listed companies are aggregate figures for fiscal years ending in March.
2. Cash earnings are for companies with five or more employees. Data are rebased to 2005 = 100. Data for 2009 are average for Jan-Oct.
3. Companies cutting wages, etc. is the percentage of companies that either have or are planning to cut wages or benefits.

Source: Nomura Institute of Capital Markets Research, based on data from Tokyo Stock Exchange and Ministry of Health, Labour and Welfare.

2. Option of contributing treasury stock to occupational pension schemes

Pension trusts, one of the main types of institutional investor, face the problem of underfunding in their defined benefit pension schemes. In the case of some companies, the shortfall is more than ¥1 trillion or more than 100% of net assets[14]. In the case of companies in deficit, the shortfall is an even higher percentage of net assets and an even greater burden.

Major US companies with defined benefit schemes face similar underfunding problems. What we would like to focus on here is moves by companies such as Boeing and Caterpillar in 2009 to address this problem by contributing treasury stock to their pension assets (Figure 7).

[14] See *Nikkei Veritas* .28 June 2009 and 4 October 2009.

Figure 7: Examples of companies that have contributed treasury stock to their pension assets

($mn)

Company	Sector	Shortfall	Treasury stock contribution	Pension assets
Boeing	Aviation & defense	▲ 8,420	1,500	40,597
3M	Capital goods	▲ 1,152	800	9,243
Honeywell	Aviation & defense	▲ 3,526	800	11,520
Caterpillar	Machinery	▲ 4,748	650	11,493
JC Penny	Retailing	▲ 275	340	3,725
Brink's	General security	▲ 329	58	440

Note: 1. The figures for the shortfall and pension assets are as of the end of fiscal 2008.
2. The shortfall is the difference between the fair value of scheme assets and pension liabilities.
3. Treasury stock contributions are the figures reported by each company. Boeing has reported the largest amount ($1.5 billion).

Source: Nomura Institute of Capital Markets Research, based on company disclosures and media reports.

What companies that do this have in common is (1) a pension shortfall in 2009, (2) the fact that they have contributed treasury stock to their pension assets to reduce the shortfall, and (3) the fact that the amount of treasury stock in their pension fund is within Employee Retirement Income Security Act (ERISA) limits (10% of pension assets). The main advantage of using treasury stock rather than cash is that it enables the companies to maintain their liquidity in the current difficult economic climate and to make a capital gain when the price of the undervalued treasury stock in their pension assets recovers[15].

Another example of the use of treasury stock in corporate restructuring, although not one related to pensions, is General Motors' use of treasury stock to pay some of its obligations to a healthcare trust set up to pay medical benefits to retired employees[16]. As a result of discussions between GM and the United Auto Workers after GM filed for Chapter 11 bankruptcy in June 2009, UAW agreed to accept a combination of common stock, preferred stock and equity warrants from the restructured company in exchange for the $20 billion that GM owed the healthcare trust and which had been a financial burden on the company. In other words, GM used treasury stock in a debt-for-equity swap to pay off some of its debt. Similarly, Ford has agreed with the same auto union to pay off $13.1 billion of what it owes to a retiree healthcare fund in stock rather than cash and has been exempted by the Labor Department from having to comply with the normal ERISA requirements[17].

[15] See Inklebarger, Timothy, "Billions contributed to boost funding levels," *Pension & Investments*, 11/2/2009.

[16] For more on GM's restructuring, see Yoshikawa, Hiroshi, "*GM ni Yoru Chaputaa Irebun o Katsuyou Shita Saiken no Yukue*" (Outlook for General Motors' Chapter 11 Restructuring), *Capital Markets Quarterly*, Summer 2009 (in Japanese).

[17] See US Department of Labor press release of 9 December 2009 (http://www.dol.gov/opa/media/press/ebsa/EBSA20091510.htm).

We think this US solution to the problem of underfunded occupational pension schemes may be worth considering by Japanese companies facing a similar problem and that contributing treasury stock to occupational pension schemes could be a practical solution to the ongoing problem created by the unwinding of cross-shareholdings in Japan.

3. Investing via investment trusts

1) Contribution of defined contribution pension schemes to the spread of investment trusts

While the ability to invest a small amount of money in a diversified portfolio and to invest directly in an investment trust is important to retail investors, experience in the US and Australia, where the market for mutual funds is well developed, suggests to us that the growth of defined contribution pension schemes has played an important role in the spread of mutual funds.

In Japan, companies have been steadily switching from defined benefit schemes to defined contribution schemes[18]. As individual employees are responsible for how their defined contribution plans are invested in the medium to long term, this may have encouraged retail investors to invest in mutual funds (or "investment trusts," as they are called in Japan).

In the US, where more money is invested in mutual funds than is deposited in time deposits, as much as 40-50% of this investment has been via defined contribution pension schemes. These schemes have therefore played a key role in the spread of retail investment in mutual funds (Figure 8). In Australia, where the transition from defined benefit to defined contribution pension schemes (referred to in Australia as "superannuation") was made compulsory in 1993, the amount of money invested in mutual funds via superannuation schemes has increased considerably since the 1990s (Figure 9)[19 20].

In Japan, too, an early resolution of the problems facing defined contribution pension schemes is needed if the investment trust market is to expand[21].

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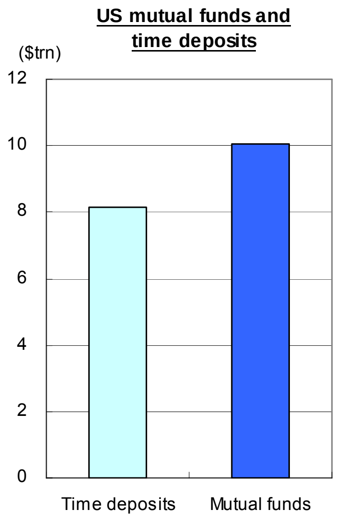
18 As of end-October 2009, there were 12,315 defined contribution occupational pension schemes in Japan with a total of 3.4 million members. According to the minutes of its board of governors, NHK plans to partially introduce a defined contribution occupational pension scheme in fiscal 2010.

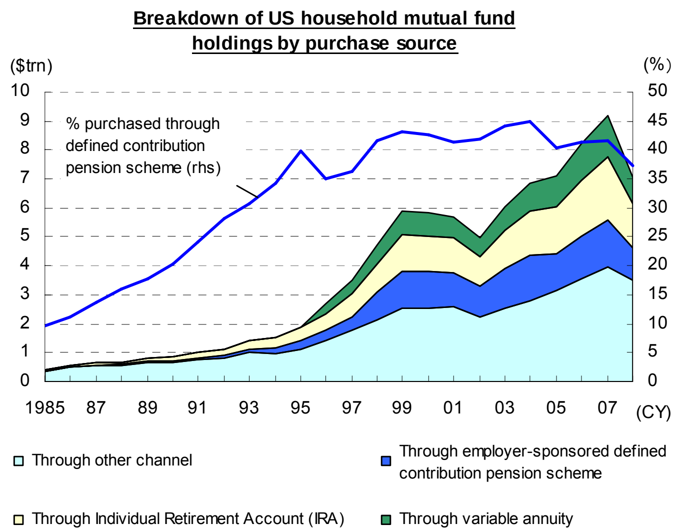
19 For more on superannuation in Australia, see Kamiyama, Tetsuya, "*Oosutoraria ni Okeru Suupaaanyueeshon no Genjou*" (Superannuation in Australia), *Capital Markets Quarterly*, Spring 2008 (in Japanese).

20 See Financial Services Agency, *Minutes of 13 March 2007 meeting of Study Group on the Internationalization of Japanese Financial Markets and Capital Markets*.

21 For more on defined contribution pensions, see Nomura, Akiko, "Proposal for Fundamentally Reforming Japan's Defined Contribution Pensions," *Nomura Journal of Capital Markets*, Autumn 2009, Vol. 1, No. 3.

Figure 8: Contribution of defined contribution pension schemes to spread of mutual funds in the US



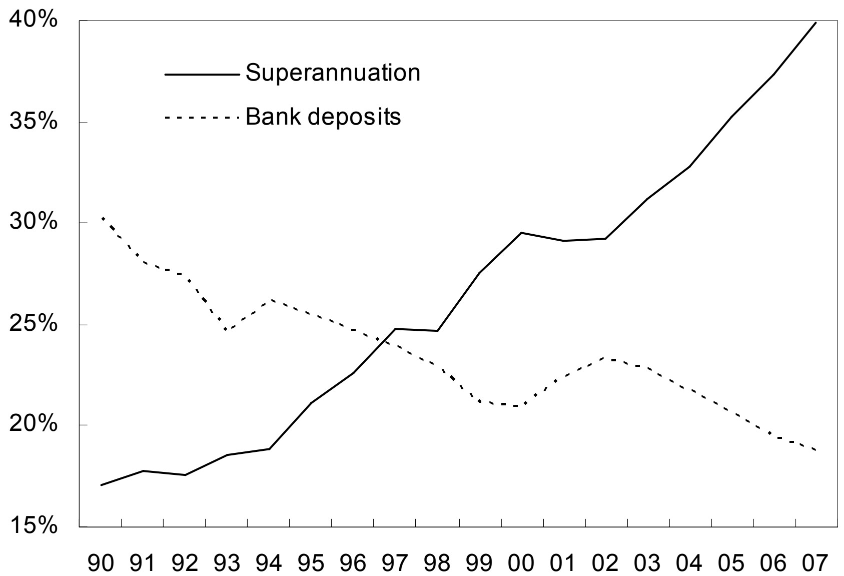


Note: 1. Figures for mutual funds and time deposits in left-hand chart are as of end-September 2009.

2. Figures in right-hand chart are as of end-2008. The data for mutual funds purchased through variable annuities are for the period since 1996.

Source: Nomura Institute of Capital Markets Research, based on data from the US Federal Reserve's *Flow of Funds* and ICI.

Figure 9: Superannuation assets as percentage of personal financial assets in Australia



Source: Nomura Institute of Capital Markets Research, based on Reserve Bank of Australia data.

2) Vesting and the transition to defined contribution pension schemes

As the transition to defined contribution pension schemes involves pension assets being administered by means of individual accounts, employees in effect receive their occupational pension and retirement lump sum in advance. As a result, once pension money and assets are in an employee's account, they are ringfenced against what may happen to the sponsor company. In contrast, as members of a defined benefit pension scheme normally begin to receive their pension when they retire (including at the age for compulsory retirement), until then they are exposed to the business risks (including possible failure) that face the sponsor company . (In some cases, pension benefits may actually be reduced[22].) Defined contribution pension schemes therefore have the advantage that pension assets, which form part of employees' remuneration, are credited to employees' pension accounts soon after they have done the work for which they are being remunerated.

4. Foreign investors

Japan's labor force participation rate (number of 15-64-year-olds as percentage of population) is still declining. In fiscal 2008 it fell below 65% and is expected to decline even further (Figure 10). This decline is one of the factors lowering the savings rate. As Japanese society ages, personal financial assets are unlikely to increase in the medium to long term if nothing is done[23]. Hence, the need for foreign investment.

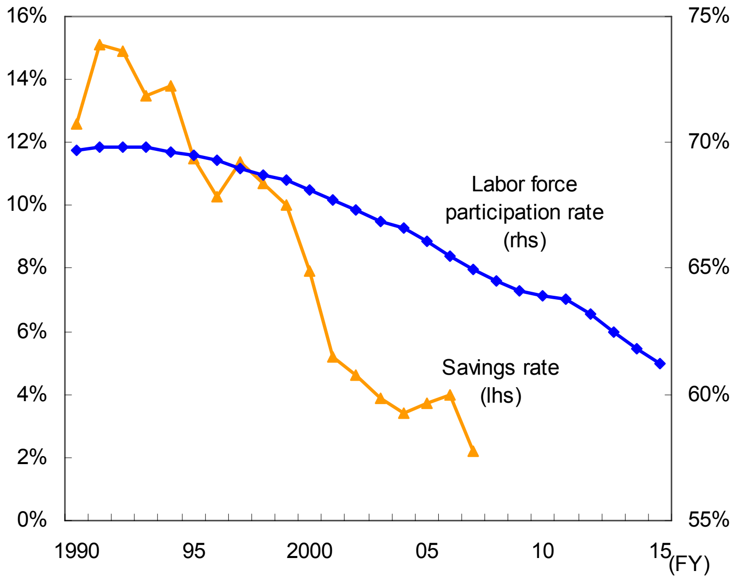
1) Investment from the Middle East and the rest of Asia

Foreign pension funds and sovereign wealth funds are particularly large institutional investors. For example, the total investment assets of the 10 largest foreign pension funds are worth some $1.9 trillion, while those of the 10 largest sovereign wealth funds are worth some $2.7 trillion (Figure 11). Many of the largest sovereign wealth funds belong to Asian or Middle Eastern countries whose high economic growth rates have enabled them to accumulate current account surpluses. These funds may continue to grow along with the economies concerned. Similarly, as the number of middle-income earners in these countries increases, retail investors there and, by extension, the mutual funds and pension funds in which they will invest are likely to become an increasingly important source of investment capital.

[22] See Rating and Investment Information, Inc., *Newsletter on Pensions & Investment*, 6 July 2009 and 17 August 2009.

[23] For more on the impact of Japan's declining birth rate and aging society on personal financial assets in Japan, see Miyamoto, Sachiko, Achieving growth in the individual financial assets of an aging population, *Nomura Journal of Capital Markets* (forthcoming).

Figure 10: Japan's savings rate and labor force participation rate



Note: Labor force participation rate data for fiscal 2006 and thereafter are forecasts by National Institute of Population and Social Security Research.

Source: Nomura Institute of Capital Markets Research, based on data from Cabinet Office and National Institute of Population and Social Security Research.

Figure 11: Major non-Japanese institutional investors

Pension funds

Rank	Pension fund/company	Country	Assets ($100mn)
1	Government Pension Fund of Norway	Norway	3,391
2	ABP	Netherlands	2,431
3	California Public Employees' Retirement System	US	2,146
4	Federal Employees Retirement System	US	2,106
5	National Pension Service	Korea	1,904
6	Postal Savings Fund	Taiwan	1,542
7	California State Teachers' Retirement System	US	1,472
8	New York State and Local Retirement System	US	1,384
9	Florida Retirement System	US	1,187
10	General Motors	US	1,103

Sovereign wealth funds

Rank	Fund	Country	Assets ($100mn)
1	ADIA	UAE	6,270
2	SAMA	Saudi Arabia	4,310
3	HuaAn Fund Management	China	3,471
4	CIC	China	2,888
5	GIC	Singapore	2,475
6	KIA	Kuwait	2,028
7	State Pension Fund	Russia	1,785
8	Hong Kong Monetary Authority Investment Portfolio	Hong Kong	1,397
9	Temasek Holdings	Singapore	1,220
10	National Social Security Fund	China	824

Note: 1. Pension fund assets as of end-2008.
2. Sovereign wealth fund assets according to most recent data available as of August 2009.

Source: Nomura Institute of Capital Markets Research, based on data from Pension & Investments and The Sovereign Wealth Fund Institute.

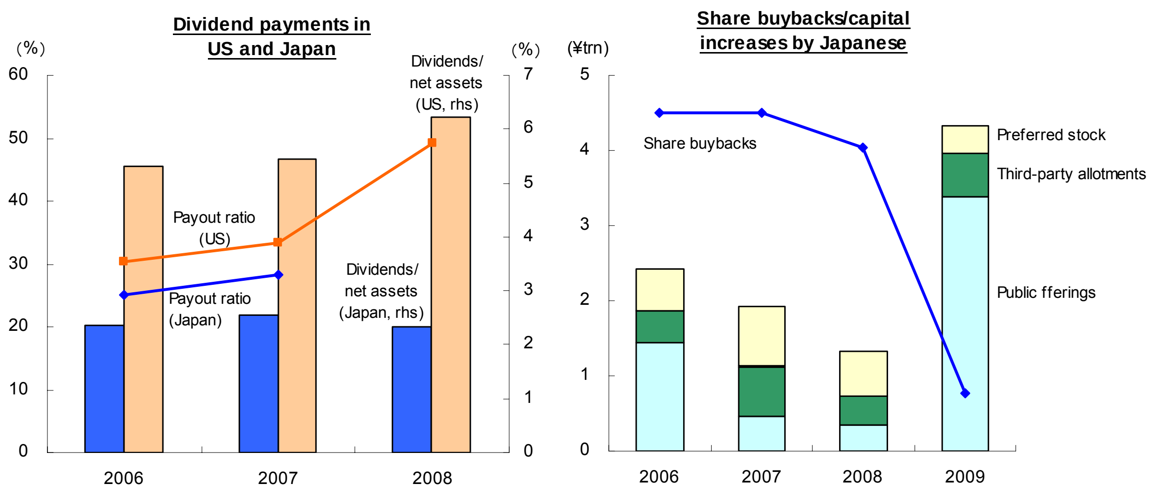
Therefore, companies that cultivate investor relations may be able to mitigate the problem created by the unwinding of cross-shareholdings if they can persuade foreign investors that they are pursuing the right policies and to hold their shares for the long term. Cultivating investor relations can help companies to give investors a realistic picture of their likely future earnings and create realistic expectations. In particular, Japanese companies have been trying to improve their profitability in recent years (for example, by stepping up their efforts in emerging economies, especially in Asia)[24].

[24] For example, Japanese companies have been using cross-border M&A as a quick way of expanding overseas. For further details, see Yoshikawa, Hiroshi, "Cross-border M&A for Global Expansion Growing in Japan Also," *Nomura Journal of Capital Markets*, Winter 2009, Vol. 1, No. 4.

This is something that it is increasingly important for them to explain to foreign investors.

As well as cultivate investor relations, companies will probably need to do more to increase shareholder returns in terms of dividends and share buybacks if they want to attract new investors. Although the payout ratio (dividends/net profits) of Tokyo Stock Exchange First Section nonfinancial stocks was more than 100% in fiscal 2008 as a result of a sharp fall in net profits, the ratio of dividends to net assets (2-3%) was only about half that of major US stocks (those in the S&P 500) (Figure 12). Similarly, Tokyo Stock Exchange companies bought back ¥763.7 billion of their own shares in Jan-Nov 2009—considerably less than in 2008 (¥4 trillion). At the same time, they raised more capital. While there may be no alternative during an economic slowdown, they will have to increase their dividends and share buybacks when the economy recovers if they want to appeal to foreign investors.

Figure 12: Dividend payments in US and Japan, and share buybacks/capital increases by Japanese companies



Note: 1. The data for dividend payments in the US is for S&P 500 stocks, while the corresponding data for Japan are for Tokyo Stock Exchange First Section stocks. Years are fiscal years.

2. The payout ratio for Japanese companies in fiscal 2008 is over 100% because of the large decline in net profit.

3. The data on share buybacks and capital increases are for Tokyo Stock Exchange First Section stocks. Years are calendar years. The data for 2009 are for Jan-Nov.

Source: Nomura Institute of Capital Markets Research, based on Tokyo Stock Exchange and Bloomberg data.

2) Giving local staff of Japanese subsidiaries in China the opportunity to invest in the parent company

As we have suggested, it is likely to be increasingly important for employees to own shares in their company. If, as Japanese companies expand their operations overseas, they set up ESOPs as an incentive to enable their employees both in Japan and overseas to invest in the parent company, these employees could be considered part of all the foreign investors available to absorb surplus cross-shareholdings. In China, for example, Procter & Gamble's local subsidiary was the first foreign-invested company to set up an ESOP that enables employees to purchase shares in the parent company[25]. As nearly four million employees work for the local subsidiaries of Japanese companies in China and there are more such subsidiaries there than in any other country, we think Japanese companies should seriously consider following the example of P&G and setting up ESOPs as an incentive to enable their local employees to invest in the parent company (Figure 13).

Figure 13: Number of local staff employed by Chinese subsidiaries of Japanese companies

	All sectors			Manufacturing		
	Number of employees	Number of expatriates	Number of local staff	Number of employees	Number of expatriates	Number of local staff
Whole world	3,889,555	42,174	3,847,381	3,078,764	21,465	3,057,299
US	457,843	8,931	448,912	284,234	3,645	280,589
Europe	351,152	4,690	346,462	205,095	1,350	203,745
Asia ex Japan	2,809,570	26,646	2,782,924	2,385,989	15,619	2,370,370
of which, China	1,134,307	10,860	1,123,447	1,009,582	6,858	1,002,724

Note: 1. Data exclude local subsidiaries where the Japanese company's total share (including any share acquired via the local subsidiary) is less than 10%. Data as of October 2008.
2. The number of expatriates is the number of employees sent from Japan.

Source: Nomura Institute of Capital Markets Research, based on data from Toyo Keizai's *Directory of Japanese Companies Abroad (2009).*

This paper is based on a presentation by the authors at a Nomura seminar entitled "Changing Business Conditions and the Role of ESOPs in Japan" (24 November 2009) but contains some additions.

25 For more on ESOPs in China, see Sekine, Eiichi, "Recent Developments Regarding the Establishment of Employee Share Ownership Plans in China," *Nomura Journal of Capital Markets*, Summer 2009, Vol. 1, No. 2.