



Japanese Orphan Companies

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Powerful buds



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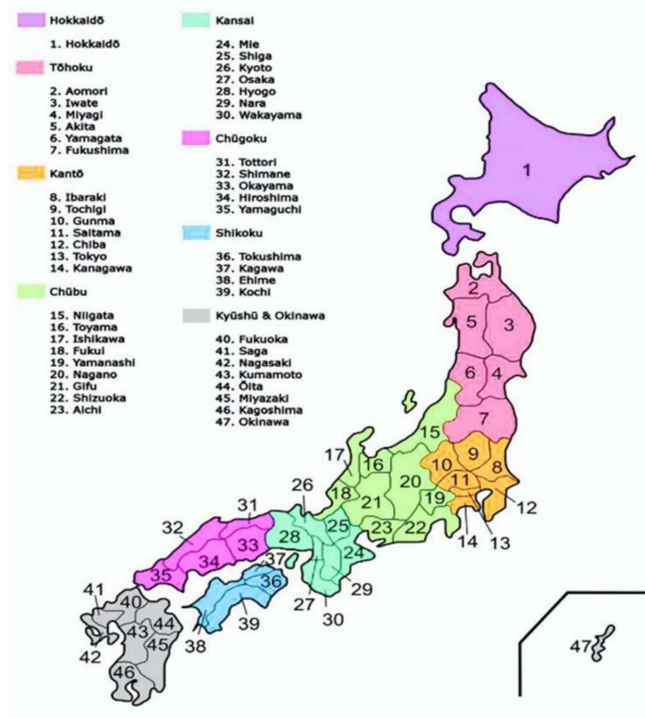
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PART ONE: Orphan companies find their root in Japan's History

CHAPTER ONE: FALL AND RISE

Introduction

Japan looks like an island, but it's not. It is an archipelago, composed essentially of 5 islands (in fact there are over 6000 although mostly very small). Honshu is the largest island, where resides not only the capital Tokyo, but also the other major cities: Osaka, Yokohama and Nagoya. To the north is Hokkaido, whose capital Sapporo sounds familiar to beer lovers. To the south we find Shikoku, a little smaller than Sardinia and with fewer inhabitants than Sicily, an island that the well-known magazine *Lonely Planet* indicates as the most beautiful destination in Japan. Continuing further south we find *Kyūshū*, famous for its wild nature, full of waterfalls, volcanoes and hot springs. Finally, much further south, we find Okinawa, the Hawaii of Japan, with its white beaches, tropical climate and turquoise waters.



Japan is divided into eight regions. The three islands of Hokkaido, Shikoku and *Kyūshū* each represents one region. The other five regions (Tohoku, Kanto, Chubu, Kansai and Chugoku) are located on the large, main island of Honshu. In turn, the regions are divided into prefectures, and there are as many as 49 in Japan. Each prefecture has its own customs, dialects, foods and uses.

Japan's geographical position within the Pacific sea, facing Korea, China, Russia, determined the peculiar historical traits that characterized Japanese economic and

political development.

This report starts with a short presentation of the history of the country, that we call Japan's legacy, that is, as always, instrumental to understand the present.

• The birth of modern Japan and the first humiliation

Japan's Tokugawa (or Edo) period

Before the Tokugawa clan took power in 1603, Japan suffered through the lawlessness and chaos of a long and dark feudal period (1185-1603). The Tokugawa period lasted from 1603 to 1867 and it represented the final era of the traditional Japanese government, culture and society, before the Meiji Restoration of 1868 concluded the Shoguns' domination and propelled the country into the modern era. The Tokugawa dynasty of Shoguns presided over 250 years of peace and prosperity in Japan, including the rise of a new merchant class and increasing urbanization. To guard against external influence though, they also worked to close off the Japanese society from Westernizing influences, particularly Christianity. However, with the Tokugawa shogunate growing increasingly weak towards foreign powers like Great Britain and USA, two dominant clans joined forces in 1868 to seize power, finally abolishing the position of the Shogun and restoring full powers to the emperors.

Who was the Shogun?

The Shogun (great warrior) was a military dictator, who ruled the country via a feudal system. Established as an institution by the first Shogun, Minamoto no Yoritomo in 1192 CE, the Shoguns would rule for seven centuries until the Meiji Restoration of 1868 CE.

Technically, the emperor was above the Shogun, but in practice, it was the reverse as whoever had control of the army also controlled the state. The emperors did maintain a ceremonial function, and their endorsement was still sought by Shoguns to give a veneer of legitimacy to their own rule.

The Shogun regime was based on a strong military and feudal structure where:

- no contact was allowed between the several casts (Nobility, Warriors-Samurai, Peasants, Artisans, Merchants).

- the military cast (samurai) and the lords were at the very top of the social structure; they owned feudal land property, they paid a yearly fee in rice to the central government for the feudal land rights and ruled within their territory independently from the central government.

- foreigners were not allowed to touch the sacred Japanese land to trade, apart from two Dutch boats a year and few Chinese traders in Nagasaki, through which necessary goods were imported. Imports during the Tokugawa era were 70% raw silk for manufacturing against silver, gold but mostly copper as the dominant export good.

The last Shogun

A hand of radical samurai therefore deposed the last Shogun, ending the Tokugawa era. The Meiji era officially began in 1868, following the "restoration of the emperor". Although the revolution was called "restoration of the emperor", it was more fundamentally an overthrow of the seven-hundred-years political domination by the warrior class of samurai. At the time of the restoration the opponents of the last Shogun were a remarkably illuminated, able and forward-looking group and when they took the political power, they carried out a real economic and social revolution. They were unhappy with the Shogun regime, mainly because Japan was very closed in its feudal, autarchic, rural, and decentralized economic and political structure. Between 1639 and 1858 Japan was largely isolated from the outside world by political choice. Trade was prohibited because foreigners, touching Japan's

sole for trade, was viewed as sacrilegious, but there were outside pressures to open up to trade from Western colonialists. Especially Americans, at the time, were trying to open new markets to sell their



US Commodore Matthew Calbraith

products in Eastern Asia. In 1858 Commodore Perry forced the Shogun government to allow trade, placing its war ships in the port of Nagasaki. It is important to recognize that Perry was not forcing the Japanese merchants to trade, he was forcing the Shogun to stop preventing trade, because the wave of modern and rebellious Japanese traders was already alive and kicking. This defeat arose nationalist sentiment and represented the trigger for the coup against the Shogunate, perceived as weak. Nationalists felt the Shogun had desecrated the sacred soil of Japan by allowing foreigners to come ashore freely. Some fanatics, called *Shi-Shi*, carried out assassinations of foreigners. Foreign fleets retaliated

by bombarding the strongholds of the *Shi-Shi*.

Soon after the event at the port of Nagasaki, a political void followed. The former Shogun (Tokugawa Iemochi) died in 1862 and Tokugawa Yoshinobu, a conservative-nationalist militant, was firstly nominated guardian of Iemochi's 3-years-old son, the baby Shogun; but shortly after he was appointed as the new Shogun himself. By this time two factions of samurai competed for the power: the conservative and the radical party, the latter modern and open to the outside world. As pressures from the radical party increased, the Shogun agreed to surrender his powers in 1867. The coup took place with the radical samurais sustaining the restoration of the emperor. Although Yoshinobu agreed to accept the results of the coup, his nationalist advisers refused, and a short civil war ensued. When the Imperial forces marched on the capital Edo (now Tokyo, meaning "eastern capital"), Yoshinobu finally convinced his troops to surrender. Yoshinobu himself was allowed to retire to Mito. Later pardoned, he was granted the rank of prince in 1902.



Tokugawa Yoshinobu, last Shogun

The Meiji restoration

This historical transition to a new regime is called Meiji Restoration or Meiji Revolution. The period between the appointment of the Meiji Emperor Matsuhito and his death is called the Meiji Era. The name of the Japanese era, called nengo or gengo, according to common practice, is chosen and



The young emperor Meiji, crowned when he was just 15 years old

assigned posthumously to the emperor. Sometimes, however, it is chosen by the emperor himself. The name connotes the era between the beginning of the regency period and its end due to death or abdication. In this case the emperor Matsuhito was assigned the name of Meiji ("enlightened rule") and he personally goes down in history as Meiji the Great or Meiji the Good.

At the time of the restoration, Matsuhito was just 15 years old and the leaders of the rebellion decided and ruled in his name for years.

The emperor was considered sacred as descendant of the sun goddess. To legitimate his sacred role, it took place a shift of the national religion from former Buddhism to native ancestral Shintoism. The unification of Japan was therefore implemented under the figure of the sacred emperor Meiji.

Japan's Industrial Revolution

Under the Meiji restoration, as seen, Japan wanted and needed to open up to international trade towards Asian countries, but it faced several problems:

- 1) Highly developed US and European colonization powers were controlling much of the Eastern-Asian markets. For example, England and France controlled the Indochina peninsula and southern China, Russia the northern China. Therefore, it was difficult to commercially penetrate those markets.
- 2) At the same time Japan's industrial infrastructure was poor and the Japanese products struggled to compete on the international markets. Products were hand-made and more expensive (especially manufacturing and textiles), whereas western mass products had already been realized by mechanical processes for a century and were significantly cheaper. For this reason, Japan was forced to start a quick industrialization: great investments were made in civil, agricultural, and military infrastructures; structural reforms were promoted to speed up trade and free market forces; manufacturing technology was imported from Europe. Thousands of French and English technicians helped the country to become an industrial powerhouse by the early XX century.

Industrialization's backup

What supported and accelerated the industrialization process was a series of political, economic and social interventions.

Firstly, it was compelling to convert the domestic political and economic feudal system into a more democratic decisional system and a modern currency-based economic regime.

Secondly, as mentioned above, the government needed to acquire expensive high technology from the western developed countries. There was no time to develop internally the required technologies to shift to a mass production to sustain export. This was at the very core of the industrial revolution of the Meiji era.

Thirdly, the government had to support urbanization, incentivising industrial work into the big cities where industrialization took place.

Constitution and Parliament

During the Meiji era, Japan was given its first constitution and a parliament was instituted (Diet), but just the richest 1% of the overall population could vote (rich samurai, nobles and merchants) and no women were allowed to participate in the elections. The emanation of the constitution required decades to be promulgated and it openly represented the interests of the emperor and the conservative "*genro*" (elder statesman and emperor's advisers), subverting the initial democratic call that started the Meiji era. The 1889 Meiji Constitution made relatively small concessions to civil rights and parliamentary mechanisms. Two factions have been facing each other, the conservative oligarchical party supporting a step-by-step change and the reformist party looking for universal rights to vote and to participate to the political life. Throughout the Meiji era the conservative party prevailed and despite the promulgated constitution and the Diet, Japan moved slowly towards the democratic civil rights. The cautious changes towards a constitutional regime were nevertheless a big step forward from the former Shogun regime. The Meiji Constitution lasted as the fundamental law until 1947, when American occupants forced the promulgation of a real democratic constitution following their own.

transition to a currency-based market economy

During the Shogunate, the decentralized economic system was organized mainly on transactions based on rice- or kind-exchange, even the land tax payments and fees from landlords to the government. There were currency-based transactions (in silver or copper coins), but just concentrated in the big poles of trade, like Edo, for the domestic market, where big quantities of goods were traded, and Nagasaki, for the authorized outside commerce (necessary imported goods). In the Edo era the big commerce was opposed by the government, according to the Confucian principle of austerity, and the Shogunate remained ideologically focused on the honest agricultural work as the basis of society. It never sought to develop a mercantile or capitalistic country.

In the Meiji era, instead, the government centralized several land properties, the biggest feudal properties became prefectures and the landlords became bureaucratic prefects, representing the imperial regime within. These ex-landlords, now bureaucrats, were paid a compensation for the lands and a salary for their mansions in government-issued bonds.

social mobility

On top of this the government, incentivizing social mobility from the lands to the cities, freed up potential independent workers, available to work in the industries for a salary. It took place a social revolution from cast-based feudal class restrictions into potential workers stemming from each cast: samurai with small compensations, peasants trying to find in the industries a better place to earn their living, last sons from small merchant and artisan casts and so on. Many wanted to work for a salary and even the salary was paid in currency instead of rice or kind.

Currency began to flow in the domestic market, common goods and services were acquired through currency instead of kind exchanges, contributing to the shift of Japan's economy towards capitalism.

Government's role in industrialization

The industrialization process couldn't be privately financed, given the huge amount of money to be quickly invested in new technologies for domestic production. The government was forced to import the newest technologies from Western countries, where the industrialization process was long on its way. It then introduced those technologies into the manufacturing industry (cotton and textiles, silk, tea, cement, sugar, beer and glass), mining, military arsenals, railways and communications sectors (telegraph and telephone). The government developed high-technology mass-production industries

over the first two decades of the Meiji era. At the end of the 19th century Japan was ready to entry on a competitive level the international commerce and this was the great economic and industrial revolution of the Meiji era and the first Japanese government-backed economic miracle, which took place before World War II.

Privatization

Starting from 1980 the government decided to sell its enterprises in manufacturing and mining to privileged businessmen with political affiliation, in order to cash in and help offsetting the huge debt accumulated from the enormous technology investments. Military arsenals, railways and communication were of national strategic interest and weren't organized for privatisation.

Business selling was highly subsidized through interest-free loan instalments to be paid within 5 to 25 years, according size and importance of business.

In 1890 the Japanese economy established itself in form of capitalism with privately-owned industries. From this political move the zaibatsu conglomerates were generated. Zaibatsus developed as monopolistic and family-led industrial and financial groups and dominated economically the next forty years, up to World War II. The Japanese capitalism evolved in the next forty years towards a business oligarchy dominated by monopolistic businesses.

A nice example of this supported privatisation with political connections was the rise of the Mitsubishi zaibatsu:

Iwasaki Yatarō, the creator of the Mitsubishi conglomerate, was born in 1835 in Aki, Tosa province into a provincial farming family. At the origin his family was a samurai family, but his great-great-grandfather sold off his samurai status to repay debts.

He was appointed in March 1870 president of the Tsukumo Trading Company, a shipping company founded on behalf of the Yamauchi clan and acquired from the government's privatisation, and soon after Iwasaki leased the trading rights. In 1873, the company changed its

name to Mitsubishi and from 1974 to 1975 Iwasaki was contracted by the government to transport troops and war materials for the national government's military expeditions. Because of this service Iwasaki was granted special privileges from the government: further government-owned ships were

The zaibatsu

The zaibatsu is a typical Japanese business organization similar to cartels or trusts. It is usually organized around a single family (the so called "clan" in the Shogunate era), with a monopolistic core business and operations in many different secondary companies and branches of the economy. Each zaibatsu owns a bank or financial activity to mobilize capital throughout the group. Zaibatsus were fundamental in Japan's industrialization process because they worked in tight accordance with the government's economic and political aims and decisions.

given for free to Mitsubishi after the expedition was finished in 1875 and at the end of this campaign Iwasaki's business counted up to 61 ships. This collaboration was at the very root of the strong links between Mitsubishi and the Japanese government, that ensured the new company's success. Iwasaki invested further in shipping linked activities, like coal mining, ship repair (located in a former strategic governmental yard) and financial services. In 1884, Iwasaki took a lease on the Nagasaki Shipyard, which allowed the company to undertake shipbuilding on a large scale, and renamed it the Nagasaki Shipyard & Machinery Works. And this was the origin of the Mitsubishi zaibatsu, one of the "big four" which dominated the Japanese economic scene up to World War II.

The emergence of imperial Japan

Japan began to look outside to find secure markets to sell its mass-production, but having gained in competitiveness and aligned to western countries, it refused to submit to western imposed trade prices and conditions. Japan then looked for colonies itself.

From this consideration Japan participated into two conflicts: The Sino-Japanese (1894) and the Russo-Japanese (1904).

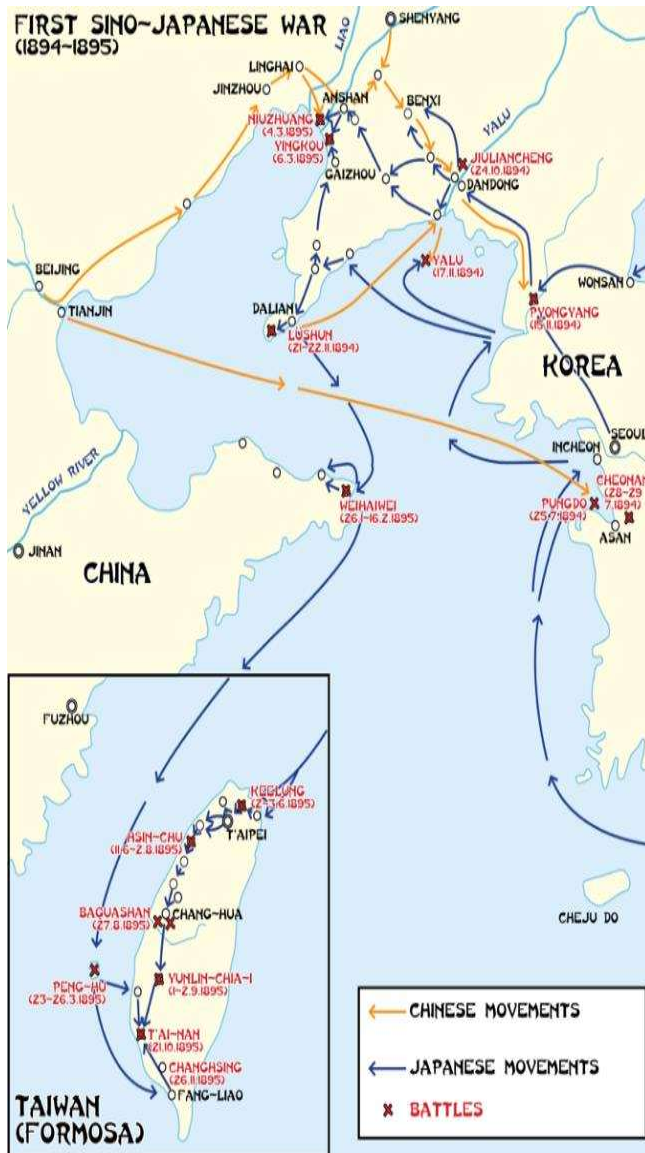
The premises of the Sino-Japanese war were the political control of Korea for advantaging in the Yellow sea international trade. China have been controlling Korea for over two centuries, despite a monarchic regime was ruling. But the monarchy was weak and submitted to foreign interference: China with its Quing dynasty was supporting the status quo for economic reasons, whereas Japan tried to force hand towards a radical reform of the country, following the example of its Meiji industrialization and development.

The army

On the eve of the outbreak Japan had an army that was equal to European armed forces in every respect. By the 1890s, Japan had at its disposal a modern, professionally trained army which was relatively well equipped and supplied. Its officers had studied in Europe and were well educated in the latest strategy and tactics. By the start of the war, the Imperial Japanese Army could field a total force of 120,000 men in two armies and five divisions.

From the end-of-war treaty of Shimonoseki in 1895 Japan gained full control of former Chinese Taiwan and Liaodong peninsula (see chart) and forced China to recognise total independence of Korea. Korea's independence was just from China and Japan gained direct control over the Korean political regime. Additionally, China was to pay to Japan 200 million taels (8,000,000 kg/17,600,000 lb) of silver as war reparations. The Qing government also signed a commercial treaty permitting Japanese ships to operate on the Yangtze River, to operate manufacturing factories in treaty-ports and to open four more ports to foreign trade.

Japan had achieved what it had targeted to accomplish and ended the Chinese influence over Korea, but the Western powers put political pressures on it to renounce to the Liaodong Peninsula with its important Port Arthur in exchange of a huge increase in financial war indemnity (for another 30 million taels of silver). The Western powers (Germany, France and Russia) supervised Shimonoseki's treaty as auditors and especially Russia didn't want Japan to retain Port Arthur, since they had their own ambitions there. Russia persuaded Germany and France to join in applying diplomatic pressure on Japan, which resulted in the Triple Intervention of 1895. The Triple Intervention was a coordinated intervention from Germany France and Russia into the



The chart represents the geographical localization of the 1895's Sino Japanese war with the movements of Japanese's land and naval troops sent against China. The chart shows extremely well the strategic importance of the yellow sea, the Liaodong and Shandong peninsulas with their main trade ports (Port Arthur or Dalian and Weihaiwei), Korea and Formosa or Taiwan island. Japan moved firstly to Asan, Korea, an antique tributary state of China, to guarantee its independence from Chinese dominance. Korea was a very weak and undeveloped country and therefore exposed to outside control. Korea directly faces Japan on its east coast and every outside domination could pose a threat to an invasion of Japan's territory. Chinese forces were rejected in Korea in Asan, northern in Pyongyang and along the Yalu river, leaving Korea's territory liberated from the Chinese troops.

The Japanese land and naval army split and moved in the Chinese territory both towards Port Arthur (or Dalian) in Liaodong peninsula and towards Mukden (or Shenyang) in Manchuria. Both were strategic cities to conquer: Port Arthur as a fortified naval port facing the yellow sea and the access to Bo Hai gulf (the gulf comprised by the Liaodong and Shandong peninsulas); Mukden instead was at the border with Russia's territory. Japan was successful on each of the main battles.

Chinese troops moved all to Shandong's Weihaiwei city, where they were again defeated by the Japanese naval troops. Few battles were fought on Taiwan/Formosa island but they were not relevant to the overall Sino-Japanese conflict.

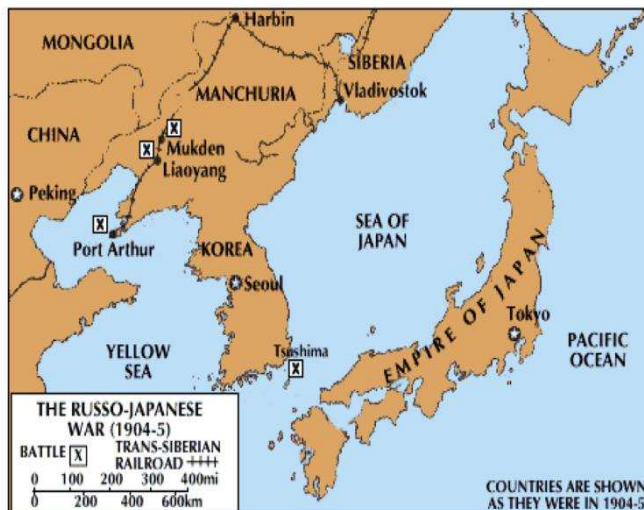
After almost a year of battles China and Japan bargained the peace conditions, according to which Japan received Taiwan, the Liaodong peninsula and the guarantee of Korea's independence.

bargaining of peace conditions in the Shimonoseki's treaty between China and Japan.

Even if UK refused to join the Triple Intervention, Japan was not directly supported by a Western power and was forced to accept European pressures, though it gained (as mentioned before) 200+30

million taels as war indemnity, more than 350 million yen, making the war a net profit, as its war fund was only 250,000,000 yen.

Few years after the Sino-Japanese war, Russia tried to expand southern from Siberia, forcing Chinese borders. At the time China was weakened from the war, from disputes with French and English diplomats on trade agreements and from internal political corruption. In 1896 Russia concluded an alliance with China against Japan, guaranteeing the integrity of the Chinese territory. The treaty allowed Russia to move freely southern up to the Liaodong peninsula with its Trans-Siberian railway construction. But Russia seized Port Arthur, because it was looking for an ice-free port in Asia and in 1898 it managed to win another agreement with China for leasing Port Arthur for 25 years. Russia thus entered into the effective occupation of the Liaodong Peninsula, from which only three years earlier it had excluded Japan.



Port Arthur

Port Arthur has been for ages a very important naval and trade port for several Chinese dynasties until the end of the 19th century. Its characteristics were the strategic access to the Bo Hai gulf and to Tianjin port (straight connected to Peking, one of the most important Chinese cities) and its deep and ice-free waters. Port Arthur was used over time as fortified naval port from which patrolling the internal coast or check on nearby Korea or just controlling trade and commerce of Northern Asia.

The commercial targeting of the Chinese territory by Germany and Russia was followed by British and French claims on few ports facing the Yellow sea. The result to the steady erosion of Chinese sovereignty was the Boxer Rebellion (1899–1900), where a Chinese peasant uprising against the foreigners invading China. Japan and the European powers intervened to suppress the revolt, and Russia used the rebellion as an excuse to pour troops into Manchuria. From there it planned to invade Korea, despite the independence that had been “guaranteed” by Japan since the Treaty of Shimonoseki.

Japan was closely following the Russian political moves around the Yellow sea and meanwhile it was able to negotiate and conclude an alliance with UK in 1902. But when Russia invaded Korea and placed there a viceroy representing the czar, the trigger for war was there. In 1904, without a declaration of war, Japanese war-ships approached by midnight Port Arthur and took the Russian by surprise, caused

several losses on the attack and blocked the harbour. After few months of confrontation including the attack of Russian garrison in Port Arthur, the battle of Mukden and the battle of the Tsushima straight, Japan won in 1905 over Russia, achieving direct dominance over Korea and establishing itself a colonial power in East Asia.

End of Meiji era: Taisho democracy

The Meiji restoration ended with the death of emperor Meiji in 1912. Prince Yoshihito succeeded as emperor and took the *nengo* (era name) of Taisho, meaning "great righteousness". A very brief Taisho era (1912-1926) followed in one of the most dynamic and complex economic, political and social contexts ever.

The kick-off of Taisho's duties was to intervene in the 1912-13's political crisis, that viewed the oligarchical party from the Meiji's regime opposed by a new socialist party oriented towards more democratic rules. The emperor curiously backed the socialist, reformist, intellectual party, but the oligarchs and the militarists were able to oppose any government decision because of a simple rule imposed by the Meiji constitution: if a single minister was resigning, the government wasn't able to rule anything and a new government had to be nominated. Unfortunately, Taisho emperor was an ill man and couldn't be able to intervene by himself in the political crisis, that carried on up to the beginning of World War I.

Concerning World War I, Japan declared war to Germany and to The Austro-Hungarian empire in 1914 in order to annex their territories in Eastern Asia. The trigger was its UK ally officially asking help in hindering the raids of the imperial German Navy in the Chinese waters. The Siege of Tsingtao (main port of the Shangdong peninsula, looking towards the Liangdong peninsula within the Yellow Sea) represented the surrender of German colonial forces.

At the beginning of the World War, Japan was just reinforcing its presence in Eastern Asia as a colonial power, but later it sent help towards Europe and participated actively into the conflict. UK asked again for Japan's powerful navy's help in 1917, this time in the Mediterranean Sea for patrolling and defending the waters for the Allies from German and Austro-Hungarian submarines. This help was accorded in exchange of UK's recognition of Japan's control on the ex-German colonies in Eastern Asia and the Shandong peninsula. World War I concluded with another big victory for Japan: in 1919 at the Paris peace conference, it sat with the "Big Four" nations, UK, The United States, Italy and France, recognized as one of the most powerful nations in the world.

Japan's small contribution to the Allies with its naval army within the Mediterranean Sea was abundantly rewarded.

In the few years of huge prosperity that followed World War I, Japan saw the emergence of a "mass society" very similar to the "Roaring 20s" in the United States. Economic growth backed the ascension of domestic socialist and communist ideas and Japanese citizens began to ask for more voice in the government, universal suffrage and for more social freedoms. Universal suffrage was accorded in 1925, though women were not yet allowed to vote. During this time Japan was significantly more open than it was either before or after. The period has often been called the period of "Taishô democracy."

Socialist but even communist ideas were spreading at this time in Japan for a number of reasons:

- the socialist party has been brutally suppressed in the former Meiji era, but now it had the chance to pretend its rights back in representing the industrial workers;
- workers were adhering to Western thinkers' (Marx and Engels) opposition to the capitalist society;
- Russia and China were developing as communist countries and were seen as ideal political regimes based on workers' sovereignty.

The oligarchical and military party were fiercely opposing the democratic line. Suddenly in 1926 Taisho emperor died and regent prince Hirohito followed, beginning the Showa era. By this time the domestic economic and political situation rapidly worsened, leaving the precedent era as a brief, one time, open and true democratic experience in modern Japan.

Military regime and the Showa era

After the Taisho period followed the Showa era (1926-1989) with Emperor Hirohito. Showa means "enlightened peace" or in some other interpretations "radiant Japan".

By the end of 1920s all the precedent welfare, economic growth, social democratisation was partly offset due to:

- a high inflation linked to war costs, which pushed down acquisition power of wages;
- a depressed demand internally (due to direct and indirect taxes applied to offset war costs);
- uncertainties on the foreign and domestic political scene.

This led to a real economic depression (the so-called Showa recession in 1926).

By this time and just after the death of Taisho emperor a military regime was able to take control of the political scene. Interpreting the not-always-clear Meiji constitution frame, the land army and the navy army with its generals were able to develop as political actors outside from the general civil appointment and were free to report directly to the emperor by-passing the government and even the war ministry.

With the militaries directly influencing the civil government, Japan began an aggressive military campaign throughout Asia, called the Pacific War. Japan decided to attack China in 1937 (second Sino-Japanese war), followed by Thailand, French Indochina, English Singapore, Malaya and Hong Kong, US's military bases in Hawaii, Wake Island, Guam, and the Philippines.

In 1941 Japan bombed Pearl Harbour and World War II started.

Conclusions: Japan's legacy

Pre-World War II Japan had a very important economic and political influence throughout Asia. It possessed several colonies included Korea, Taiwan and some parts of northern China and also one of the strongest military powers.

Before World War II the nation had a steadily rising GDP due to an ongoing important industrialisation process, together with a very nationalistic and military regime highlighted by the slogan **fukoku kyōhei** ("enrich the country, strengthen the military").

Despite its welfare and industrial modernization successfully implemented in the Meiji era, the situation from a social point of view was still feudal, especially in the lands outside the big cities and linked to an emperor, whose role was sacred, authoritarian, and not democratic at all. The Meiji constitution was "given" by the emperor to the population. The Diet was set, but few very rich people could vote on it until 1925 and even at the time women couldn't vote at all. Democracy was not real and it was substituted for up to two decades by a military regime. And to finish with, the family-led zaibatsu conglomerates controlled most of the economy in agreement with the political regime.

- World War II, the second humiliation

The occupation

Japan entered the second world conflict as a powerful imperial nation, and it withdrew in 1945 having paid a huge price in significant destruction and depletion of its former prosperous resources.

FIGURE 1: MAN STANDING IN THE RUBBLE OF THE BOMBING AT HIROSHIMA



Source: forces.net (2019)

Japan's withdrawal from the World War II in 1945 was followed by a large presence of American forces in the country. The United States representing the Allies forced Japan to implement several reform policies. Some of these major policies included:

- the establishment of a new democratic constitution; the empire was disbanded, and the emperor retained his role of "symbol of the state and of the unity of the people" but he was no more sacred or inviolable; the Empire of Japan became the State of Japan;
- the implementation of an agriculture land reform; agriculture land reform was part of the democratisation process forced by the Allies, in agreement with the Japanese post-war leaders; the US forced absentee landlords to sell their big amount of land to the government in order to redistribute it to smaller farmers at small prices; this imposed selling amounted to a real expropriation considering the post-war economic situation;

- the implementation of a labour reform: the democratisation of working conditions, laws on trade unions and labour relations modelled on the American New Deal legislation were passed and a strong union movement was initially encouraged.
- the break-up of the anti-democratic zaibatsu groups (see an introduction to zaibatsu in the box on page 12, Meiji era paragraph).

The zaibatsu ("wealthy clique") was an industrial and financial conglomerate business that mainly existed pre-World War II in the Japanese economic context. The group was family-owned, holding-controlled, monopolistic, diversified in several sector activities and with a main core bank that distributed capital within the group.

The Zaibatsus gained control over significant parts of the Japanese economy from the Meiji period until the end of the war. Their creation started with the governmental industries privatisation in the Meiji era, but their roots go back into the Shogun period, where feudal samurai or noble family "clans" controlled in their territory the economic and political frame.

The conglomerates included at the time 4 big names ("the Big Four"): Mitsubishi (see Japan's legacy section, Meiji era paragraph), Sumitomo, Yasuda and Mitsui. They were the equivalent of the family-run groups in other Asian countries such as the Tata in India and the Charoen Pokphand in Thailand. By the start of World War II, the Big Four Zaibatsus had direct control of over more than 30% of Japan's mining, chemical and metal industries, almost 50% control of machinery and equipment market, a significant part of the foreign commercial fleet and 70% of the overall commercial stock exchange. They had tight relationships to policy makers and actively collaborated with them to sustain economic growth.

- stock markets: the post-war period (1945-1949) also saw the closure of Japanese stock markets as all equity exchanges were suspended. Stock trading was prohibited from 1st August 1945 and only resumed on 16 May 1949.

Zaibatsu and Keiretsu

zaibatsu

Zaibatsus were a real mighty economic presence and initially they worried at the most the Allied Occupation Forces. Nevertheless, the dissolution of these groups was never completely achieved. The US government rescinded the orders for a practical reason. US needed to support Japan's quick post-war reindustrialization to oppose the spreading Communism in Asia. Ultimately Japan was reassessed

in the American global geo-political strategy, from enemy to capitalist bulwark towards China and Russia. Economic recovery and stabilization were of paramount importance to contain Soviet and Chinese Communism. US therefore changed political strategy and incentivised full collaboration between Japanese policy makers and zaibatsus to re-establish pre-war business ties to support economic recovery.

The reflection of these historic business relationships and control structure can be seen in today's industrial and financial groups:

the protected links of workers and management to the group, which makes ineffective any business reorganization through incentivized retirements and redundancy policies;

the diversified structure of small medium companies;

the cross-shareholding structure still impacting the stock market and so on.

keiretsu

The forced dissolution of some of the biggest zaibatsus post World War II led to a looser and more flexible reorganisation of the old conglomerates, the keiretsu ("system, network of enterprises"). The keiretsu is an informal network of sector-integrated Japanese companies present in different industries such as automotive (it is a key element of the manufacturing industry) and banking.

There are two keiretsu types:

a horizontal organisation also known as a financial keiretsu, which has ties to a major core bank and includes companies such as Mitsui, Mitsubishi, and Sumitomo (former zaibatsus);

a vertical keiretsu, which is a form of a supply chain for member companies. The integration is not conglomerate-based like the zaibatsu but just supply-chain based in the manufacturing or distribution businesses (Toyota).

The keiretsu organisation provides real competitive advantages for its members. For example, through stable access to supplies from companies within the organisation, as well as strong bank ties which allows them to easily access bank financing. Keiretsu-associated companies favour long-term development as opposed to short-term financial gains. In addition, most keiretsu companies own small portions of shares in other companies belonging to the group, the so called 'reciprocal or cross-shareholdings', which lowers the free-float available for public trading of related companies, stabilizing fluctuations in the equity market and protecting from hostile takeovers. Although the ties

of keiretsu groups provide a buffer in periods of economic downturns, the organisation has been recently under increasing internal and external pressure to reform.

commercial banks

Another relevant effect of the reorganization of old zaibatsu's ties has been the opening up of group companies to external bank financing. In the pre-war 1934-36 period, over 80% of all industrial investment came from within the corporation (zaibatsu's ties), either through retained profits or new shares, with the rest comprising outside sources of capital. By 1951 sources of industrial funding had radically altered: almost 75% of all capital investment was derived from outside sources, leaving only about 25% to be internally sourced. Especially manufacturing found itself over the years highly exposed to bank financing. As of a post-war state subsidy to support growth, interest rates were tax deductible and therefore manufacturing companies had important advantages to source capital through bank credit.

This changed business system was at the very core of the following economic miracle and paved the way to the great banks' exposure to the 1990s post-bubble financial crisis.

back to history

Back to history and after World War II, Japan lost influence over its former colonies. The nation's GDP dropped drastically and inflation soared. The burdens of the post-war period led nevertheless in the following years to an exponential economic recovery, supported by a series of endogenous and exogenous causes:

- the shift from low to high productivity and efficiency-driven industries,
- the shift of employment from primary to secondary to sustain industrial growth,
- the commencement of the Korean war in 1950, which saw the US as main sponsor and client of all heavy production delivery; core investments and high efficiency-driven industries were priority industries like steel and iron, naval transports, energy, coal mining. The US transformed Japan into their base for military operations and outsourcing of war material.

Conclusions

After losing World War II, a very florid imperial nation was humiliated. The governance of its democracy, as well as its economic system, were reorganized by the US. At first the US imposed a new constitution, a tough agricultural property regulation favouring the small farmers, a new labour reform, the closing of the stock markets and the breaking up of the biggest family-owned zaibatsu's conglomerates.

But when it proved politically necessary to shelter Japan from the spreading Communism in Asia, the US changed political strategy and favoured a quick reindustrialization of the country. This was possible looking back to old business and political ties, linking Japanese policy makers to zaibatsu and keiretsu groups.

With the Korean war the US transformed Japan into their base for military operations and outsourcing of war material, triggering a quick economic growth in heavy production industries.

Japan was ready for its fast path to recovery, benefiting in full of the prosperous economic post-war environment.

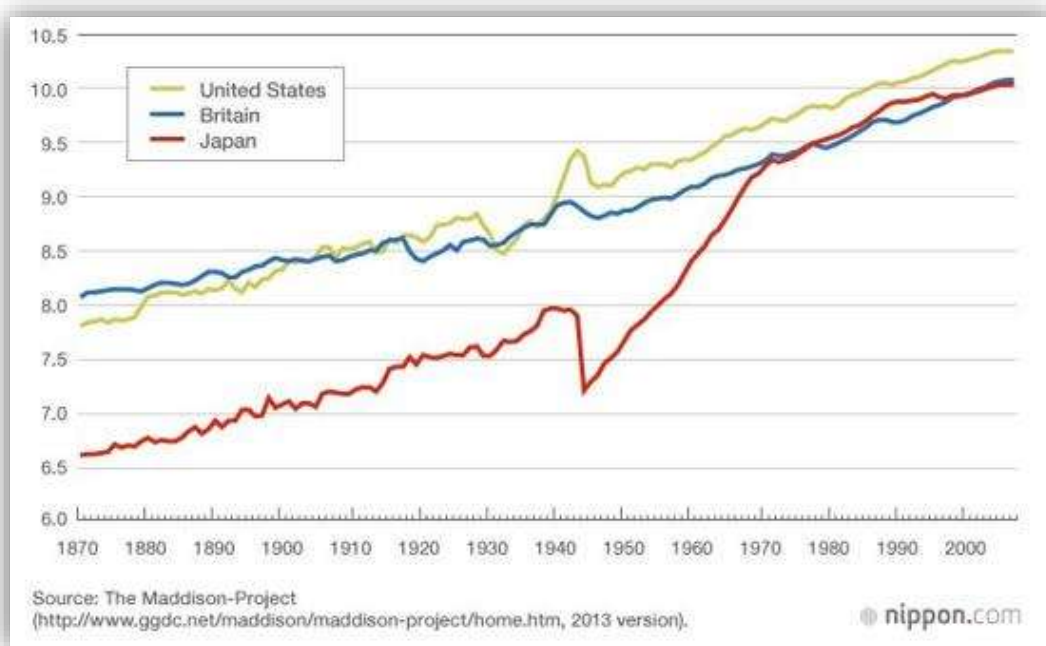
- The miracle economy (1950-1984)

Protectionism and innovation

Post-World War II Japan experienced a period of rapid economic growth called “Economic Miracle”. The name was given in 1962 by the business magazine *The Economist*. This rapid growth has been driven by various internal reform policies and further supported by the US demand related to the Korean war. During this time, the government implemented protectionist trade policies to boost the domestic economy.

From the 1950s onward Japan began to rebuild itself through an industrial revolution in various sectors ranging from manufacturing, chemicals, construction, agriculture, mining and infrastructures which drove the recovery of the nation's economy. Up until the 1970s there was a period of important economic expansion, very good employment rates and high GDP growth.

FIGURE 2: GROWTH IN REAL PER CAPITA GDP IN JAPAN, UK AND THE US (1870- 2008)



The chart above (Figure 2) shows how Japan had a steadily rising GDP before World War II and how this increase accelerated between 1950 to 1970, recording an annual growth close to 10%.

As anticipated in the former chapter, Japanese industrial manufacturing shifted during the 1950s from light to heavy industries and to high-productivity high-technology production.

In alteration of the 1947 Fair Trading Act Japan removed US imposed restrictions to corporate ties and stock ownership among financial institutions and corporations. This helped to reconsolidate former

zaibatsu groups, which coexisted with the new keiretsu business relationship form. The old collaboration between the Japanese policy makers, administration and corporate groups was restored to assist the development of high productivity industries. Important industrial investments without this collaboration wouldn't have worked as well as they did.

But a pivotal new outsider player entered the economic political game. As anticipated in the former chapter, commercial banks provided a big share of private capital to the industrial sector, especially in manufacturing. This increased exponentially for the first time ever the industry's exposure to bank financing and therefore its overall debt/equity ratio.

The administration intervened by concentrating these huge investments in key sectors and industries with priority production systems through its links to keiretsu's groups. It implemented industrial supporting measures as well, such as allowing the deduction of huge interest rates payments from taxes (even with low interest rates) and imposing low revenues taxation. The result was a Japanese industrial frame with investments concentrated in high value added-, high labour productivity-, high efficiency- and high-technology production, in which Japanese companies specialized.

The collaboration between zaibatsu and keiretsu production groups, private commercial banks and the government (administration) have all been crucial in contributing to the economic miracle.

The period from 1965 to 1970 has been referred to as the Izanagi boom. Izanagi was the name of a creator deity in the Japanese mythology. The 57-month period was marked by an explosive growth in GDP and an overall expansion of the Japanese economy. During the 1970s the Japanese economy established itself as a manufacturing powerhouse engaging in exports with western countries and as an export-led economy. Estimates showed that, compared to other countries, Japan had an industrial output concentrated in automobiles manufacturing and parts, metal working, steel, chemicals and consumer electronics.

By mid-1980s Japan had surpassed UK to become the second largest economy globally after the United States (Figure 2).

Conclusions: the miracle economy

Implementing protectionists trade policies, investing in technological efficiency (mainly in manufacturing industry and consumer electronics) and human capital together with an efficient use of resources, Japan's economy underwent an explosive growth in GDP, aligning to the main world's economies and even surpassing the UK to become the second largest economic power after the US.

FIGURE 3: TOKYO 1964 "SKIYABASHI CROSSING" JAPAN PRESS RESEARCH INSTITUTE / KK KYODO NEWS



FIGURE 4: 1964 NEW YORK CITY, TIMES SQUARE, DAY



CHAPTER TWO: THE BUBBLE

• Plaza Accord (1985): the sacrifice of the Yen

FIGURE 5: HOTEL PLAZA, NEW YORK



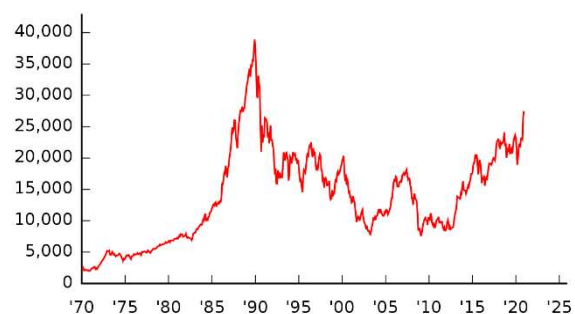
The Plaza Accord was a foreign exchange rate policy intervention by the G5 (group of five largest industrialised countries, US, UK, Japan, Germany and France) to realign their exchange rates and to reduce global trade imbalances, particularly between the US towards Japan and Germany.

After World War II the US became the hegemonic power on the planet; it grew and expanded, cashing in on dividends from a great war it had won whilst also benefitting more than proportionately from the global recovery. However, towards the end of the 1960s a series of problems arose that slowed growth: Vietnam, the oil crisis, and inflation. The US fought inflation at the cost of economic growth, but by 1983 inflation went down and the economy was recovering. It was the time of Reaganomics, based on supply-side theories, and the desire and need to take back lost opportunities. While fighting inflation, Volcker (Fed's chairman, US' central bank) raised interest rates dramatically (1980-1982) and then when Reagan came into office, the nation's fiscal policy was rapidly expanded (1983-1984). This led to an increase in the value of the US\$ and the US trade deficit. By 1985, the US\$ had appreciated by approximately 44% against other currencies and US economy was facing a trade deficit of 122 billion US\$. During this time, there were countries like Japan and Germany, who were enthusiastic about producing and less so about consuming. In some way the US needed to balance its deficit.

FIGURE 6: JPY/US\$ EXCHANGE RATE, 1950-2020;



FIGURE 7: NIKKEI 1970-2020



This all led to the Plaza Accord. The US using moral suasion persuaded the two great losers of the Second World War to accept a resetting of exchange rates. But while Germany was cautious, Japan appeared enthusiastic. This was a chance for Japan to play a decisive role in the world political arena again.

Bretton Woods

Bretton Woods Agreement refers to a set of rules decided internationally at the conference of Bretton Woods in 1944. The agreement provided for a system of fixed exchange rates based on the exchange between US\$ and the domestic currency of the participating countries. The reasons for implementing this monetary regime was to encourage by committing members to an open system of the convertibility of their respective currencies into other currencies and to free trade. In the past another system was followed by actively trading countries: the international monetary system based on gold conversion of the domestic currencies, called the gold standard. The US\$ thus took over the role that gold had played under the gold standard in the former international currency system.

What emerged was a so-called "pegged rate" currency regime. Members were required to establish a parity of their national currencies in terms of the reserve currency (a "peg" to the US\$) and to maintain exchange rates within plus or minus 1% of parity (a "band") by intervening in their foreign exchange markets (that is, buying or selling US\$). JPY was pegged in 1949 at 360 (meaning, 1 US\$ was exchanged for 360 JPY).

The system remained in place up to 1971, when the US could no longer afford to supply its currency to the world, due to the fact that they had a huge trade surplus and increasing inflation. After the US, several other countries left the pegged conversion to the US\$, leaving the international currency market free-floating.

Japan was targeting a 10-12% appreciation in JPY.

Apparently one of the reasons why Japan like Germany, who were both export-led economies, had to let their currency appreciate and exports to be less competitive was in order to concentrate on the domestic market and stimulate the internal demand. Therefore, consumption was to be achieved through expansionary monetary policies. For Japan there was another reason: Reagan tried several times to convince the Japanese government to remove its protectionist policies in order to be more competitive internationally and to invest in the USA, basing part of its business activity there. Moral suasion won and the agreement was signed.

After World War II and according to the 1944's Bretton Woods Agreement, the Americans fixed

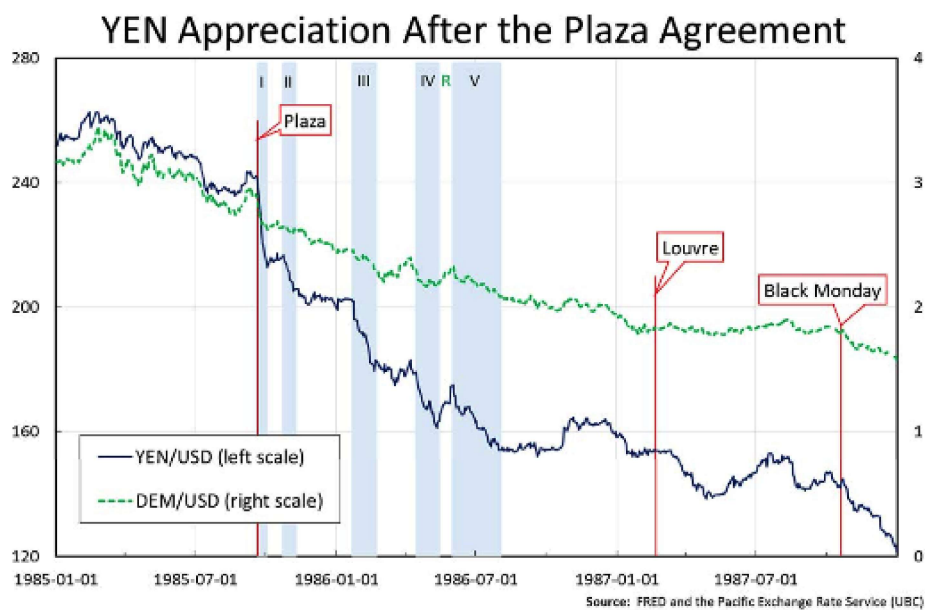
the US\$/JPY exchange rate at 1 to 360. Until the beginning of the 1970s this exchange rate remained fixed and it was abandoned in 1972. By September 1985 and few weeks after the Plaza accord the JPY had strengthened by more than one third to 235 (figure 6, page 27). Less than a year later, in July 1986, the JPY was trading at around 160. In the two years following the signing of the Plaza Accord the US\$ depreciated and the trade deficit reversed. In the three-year period from September 1985 to September 1988 the JPY appreciated by approximately 61% against the US\$, well above the targeted 10-12%. The Japanese trade surplus, formerly driven mainly to export towards US, began to decline following the US\$ depreciation, and Japan turned to Asian countries to maintain competitiveness in the export market. The Plaza accord implementation was problematic and it was indeed followed by a Paris accord, but the situation was already completely out of control.

This clearly led the Japanese central bank and government to compensate for the loss of economic growth with expansionary monetary and fiscal policies for an already euphoric securities and real estate market. Between 1985 and 1987 BOJ intervened five times by cutting interest rates and

pushing the cost of credit down from 5% to 2.5%. The economy boomed and the banking sector started to offer cheap credit without project risk assessment. From the Plaza Accord (September 1985) to the end of 1989, Japan's stock, property and land markets tripled, creating one of the largest bubbles in history. When the bubble burst in 1989, the JPY was trading at 125 to US\$. 20 years earlier it had been worth 360. Five years earlier it was 260. Today, 30 years after the bursting of the Japanese speculative bubble, despite a stagnant economy, the JPY has remained extremely strong (see chart JPY/US\$).

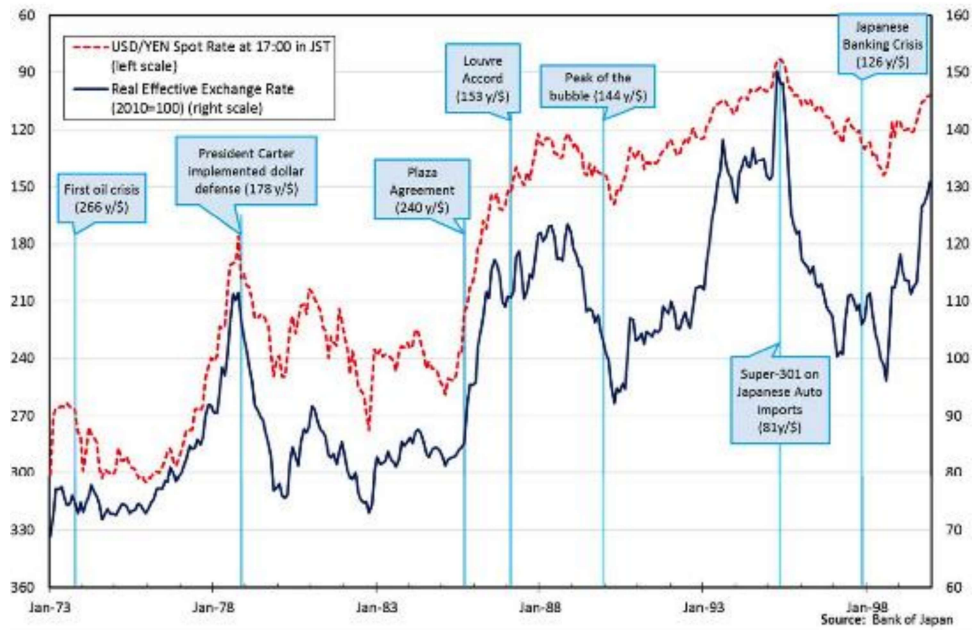
Without the Plaza Accord, Japan would not have embarked on expansionary monetary and fiscal policies at an already euphoric market stage, and the bubble would not have existed or at least would not have been so large and difficult to reabsorb. Moreover, the weaker exchange rate would have helped the country to sustain the economy, whereas a strong exchange rate prompted corporate restructuring and cost cutting to maintain competitiveness, which in turn increased deflation.

FIGURE 8: SPOT JPY/US\$ AND DEM/US\$ EXCHANGE RATE, JANUARY 1985-JULY 1987



Source: Working Paper, The Plaza Agreement and Japan: Reflection on the 30th year Anniversary, Takatoshi Ito, Ph.D. Professor of International and Public Affairs, School of International and Public Affairs, Columbia University © 2015 by the James A. Baker III Institute for Public Policy of Rice University

FIGURE 9: NOMINAL VS REAL JPY/US\$ EXCHANGE RATE, JANUARY 1973-DECEMBER 1999



Source: Working Paper, The Plaza Agreement and Japan: Reflection on the 30th year Anniversary, Takatoshi Ito, Ph.D. Professor of International and Public Affairs, School of International and Public Affairs, Columbia University © 2015 by the James A. Baker III Institute for Public Policy of Rice University

- Speculation: the great Japanese bubble

The bubble economy (1985-1990), Baburu Keiki

Real estate market: preparing the way

Since World War II the Japanese economy has experienced large increases in big cities' real estate prices due to the urbanisation that followed the industrial boom. However, the increase during the bubble economy was by far the largest ever recorded since data became available in the 1950s. It is widely documented that the real estate bubble in Japan in 1989 was tightly linked to the expansion of the construction business in the big cities. In comparison, agriculture land prices remained low or further decreased in most rural areas of Japan.

The main causes of the extraordinary rise in real estate prices have been attributed to several key-drivers including:

- easy access to property financing:

following the Plaza Accord of 1985, the government, as seen, implemented expansionary monetary policies cutting rates and between mid-1987 and mid-1988 the money supply had increased by approximately 10%. This greatly favoured business access to cheap bank financing, but companies were also able to raise funds through alternative means such as shares, bonds and warrants issued on the lively securities market. This large value of excess funds was then invested in real estate, particularly in central Japan, and into stock markets.

- urbanisation:

post-war changes of Japanese economy saw concentrated economic activity in Tokyo. During the 1980s there was a rapid change both in land and property ownership as in land use in central Tokyo. Land use moved from being mostly residential to commercial. Ownership became concentrated amongst large corporations. The share of land owned by corporations increased from 24.9% in 1985 to 28.7% in 1989, and the share owned by individuals decreased from 75.1% to 71.3% during the same period.

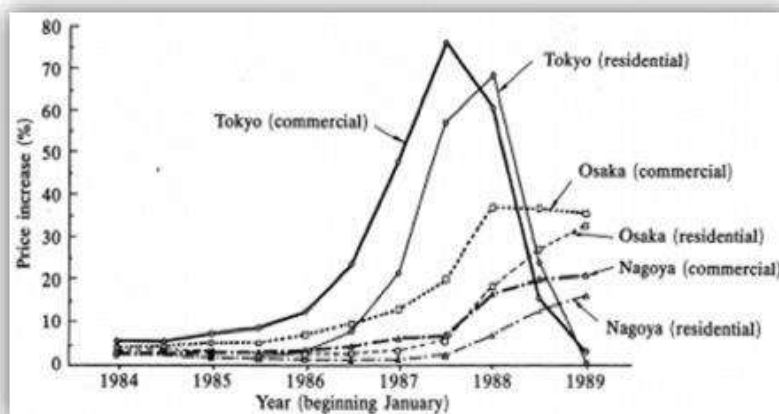
- loose regulations on land use and building following the general government's deregulation policy supported by the new concept of *minkan katsuryoku no katsuyo*, 'utilising the ability of private enterprises'
- bullish expectations, overconfidence and speculation (known as the "human factor" or "moral hazard" in the securities market).

Speculation

Speculation refers to the purchasing of an asset with the expectation that its value will increase in order to take profit selling it in the future (arbitrage). Under certain market circumstances this may lead to the formation of a speculative bubble in which assets are grossly mispriced and inflated beyond their intrinsic value, against the general principle that equity markets reflect the economy's status of a country. In real estate, as opposed to common land acquisition (a land is acquired for construction purpose and utilisation), speculative land acquisition means that land is bought with the expectation that its value will increase and be sold to make profit.

The asset price bubble in Japan in the 1980s is one of the iconic examples of a financial bubble, driven by speculation in the real estate and stock markets. As mentioned before, this speculative land acquisition during the bubble period was highly leveraged due to the easy availability of credit from banks and other non-financial institutions.

FIGURE 10: THE SPREAD OF THE RISE IN LAND PRICES IN TOKYO, OSAKA AND NAGOYA (1984- 1989)



Source: Economic Planning Agency (1989)

Real estate market: mad speculation

Many companies started at the time to sell each other land properties at inflated prices, allowing them to record profits and to revalue the land held in stock. For example, in 1985 the Daikyo Kanko

Company, a Japanese real estate company acquired a 0.7 ha site in the Chiyoda ward of Tokyo valued at JPY57.5 billion, which was triple the average land price in central Tokyo at the time. This trend was also common amongst other Japanese real estate companies such as Sumimoto Realty, Mitsubishi Estate Company and Mitsui Real Estate Development Company.

To figure it out, in 1985 Japan's land value to Gross National Product (GNP) compared to US's land value to GNP was in a ratio of 2.88:1. Given the much smaller land availability of Japan, this figure, adjusted for available land, implies that Japanese land prices compared to the US were overpriced by 80–120 times. From 1985 to 1987, the ratio of Japan's land value to GNP, compared with the US's land value to GNP, increased furthermore to 4.3:1 (Economic Planning Agency, 1985). Again, it is reported that the Imperial Palace grounds in Tokyo at that time were worth more than all of California.

Due to the easy access to financing, Japanese corporates went beyond the domestic market and began to invest even in real estate in foreign markets. Japanese property investments in the US market rose from 1.9 billion US\$ in 1985 to 7.5 billion US\$ in 1986 and 16.5 billion US\$ in 1988.

Equity market: induced bubble

Real estate market and speculative land acquisitions heavily affected securities market. The rise in stock prices in the 1980s before their sharp decline in the 1990s has been attributed to the high level of expectations that general asset prices including real estate (as seen before) and stocks would increase. Although many investors acknowledged at the time that Japanese stocks were highly overvalued compared to their fundamentals, they also anticipated that in the short-term the stock price would not decline as other investors would be willing to buy and hold at the prevailing high price (moral hazard). During the financial bubble, equity prices could not be justified by fundamentals. Instead, they were based on investors beliefs that returns would consistently increase for a while.

The market was so overpriced that Japan's capitalisation at the end of 1989 was as big as the US's, with the real economy being as much as half of the US's. Papers indicate that at the peak of the bubble Japan's market cap was about 45% of the overall global market cap (with the US at 33% and UK at 8%).

Equity market: IPOs in the bubble

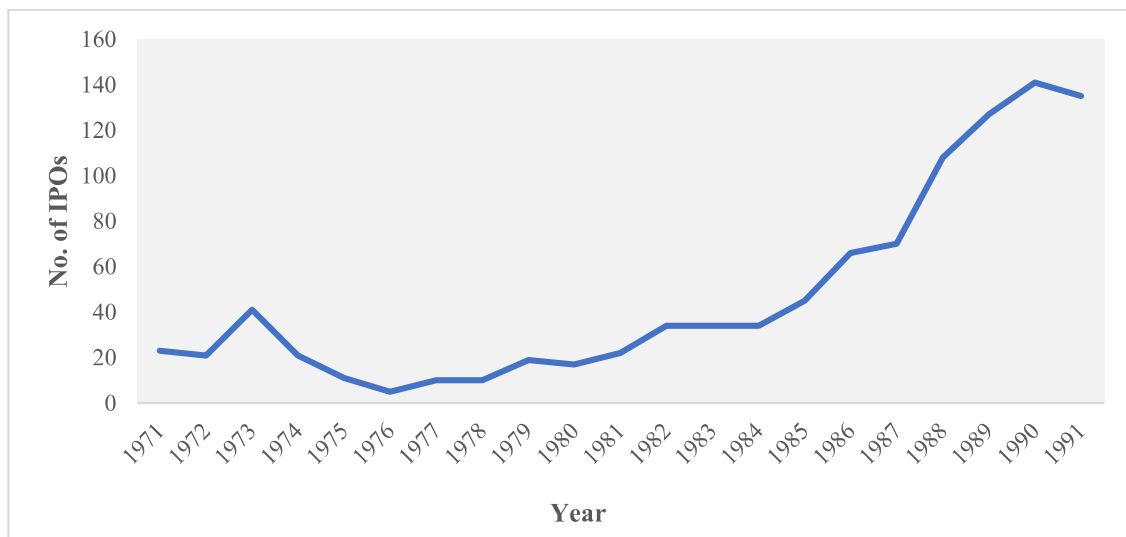
The cycles in IPOs volumes are partly due to firms successfully timing their offerings to take advantage of mis-valuations by investors. Let's look at IPOs in the bubble booming Japanese stock market.

Deregulation

Prior to March 1989, IPO offering prices were set with reference to the multiples of 3 comparable firms and the Tokyo Stock Exchange (TSE) required 5 years of operating history to allow a company's listing. The Japanese government had meanwhile liberalized the listing regulations in several stages in order to support liquidity into the stock market and since November 1983 requirements have been relaxed, permitting younger firms to go public. This led to substantial growth in the number of new listings on the Over-the-Counter (OTC) market.

In April 1989, an auction system was introduced for setting the offer price, although offer prices were subject to minimum and maximum levels (3076 above the reference) which were determined by using comparable firms. In January 1992, further reforms were instituted, including the abolition of a maximum price and allowing the offering price to be set below the price determined in the auction.

FIGURE 11: JAPANESE IPOs FROM 1971 TO 1991



Source: Constructed using data from Loughran et al, 1994

IPOs in the bubble

Figure 11 above shows the steady rise in IPOs from 5 in 1976 to 141 in 1990. Drops in number of IPOs can be noticed around late 1972 and late 1978 possibly related to the oil crises. Peaks can also be noticed in 1986 when stock prices began to increase rapidly as well as in early 1989, just before the burst of the asset price bubble. The capital raised by Japanese firms in the financial markets rose substantially in the late 1980s. For instance, in 1984 the overall value of newly issued securities by all listed companies was around 5.4 trillion JPY. That figure increased to 28.4 trillion JPY in 1989. In this

sharp increase of securities funding in the Japanese market, foreign investors played a key role as reported in Table 2 below.

Equity market: bubble burst

The # 1 cause of the bubble burst was the BOJ's intervention in increasing interest rates in order to control inflation. Inflation grew due to the expansive monetary policy implemented to offset the JPY appreciation following the Plaza accord and was fed by the financial bubble. The interest rates cut was the trigger for the bubble burst and, as highlighted by Japan Times in a recent article, among all the financial bubbles created on the several global markets, Japan's was the only one where the government and the BOJ induced actively the burst. "Japan's bubble experience is fundamentally different from other financial bubbles. This is because it was the only bubble in history that was proactively burst by the ruling elite" writes Jesper Koll from Japanese Times. The clear intention to intervene in the bursting of the bubble is presented in the inaugural opening speech of the newly appointed BOJ governor, Yasushi Mieno on 17 December 1989: "Thank you for appointing me to become your head of the central bank. Bad things are happening in our country. A graduate from the top university, entering a top company can never ever dream of owning and living in an apartment within a two-hour commute from his office. This is bad for society, this is bad for our future; this is a bubble, and I will burst it."

"He immediately hiked interest rates at record speed — bond yields surged from 3% to 8% within nine months of his taking office. Stock markets were even faster to take him seriously: The Nikkei peaked a mere 12 days after his speech and had practically halved by the time the first anniversary of Mieno's inaugural speech came around".

In few months Japan went into deep recession. Recession that still weighs on the Japanese economy despite several monetary and fiscal policies implemented to support growth in the following years up to date.

IPOs and securities market

By late 1990, when the bubble burst and the economy went into recession, there was a reduction in equity financing for companies and the weakening of the stock market led to a strong value decrease of Japanese businesses, mostly in real estate and construction.

TABLE 1: STOCK FINANCING BY JAPANESE LISTED FIRMS (1972- 1998)

Year	Total (million yen)	Distribution (%)		
		Public offering	Warrant Exercise	Other
1972	1,041,409	63.9	0.0	36.1
1973	939,266	60.2	0.0	39.8
1974	544,007	51.0	0.0	49.0
1975	1,001,104	22.1	0.0	77.9
1976	688,723	70.9	0.0	29.1
1977	922,601	65.4	0.0	34.6
1978	896,653	63.1	0.0	36.9
1979	953,439	65.9	0.0	34.1
1980	1,052,076	83.7	0.0	16.3
1981	1,926,415	72.5	0.0	27.5
1982	1,349,335	79.5	0.2	20.3
1983	801,757	58.8	3.8	37.4
1984	1,043,132	78.1	6.3	15.6
1985	859,113	58.9	16.0	25.2
1986	872,514	45.8	42.7	11.4
1987	3,013,048	46.3	35.6	18.1
1988	4,782,307	54.0	27.4	18.6
1989	8,848,608	65.9	24.7	9.4
1990	3,792,439	52.1	17.9	30.0
1991	807,733	15.6	44.6	39.8
1992	419,907	1.0	48.4	50.7
1993	822,790	0.9	75.0	24.1
1994	935,740	14.6	48.2	37.2
1995	638,413	5.2	46.9	47.9
1996	2,073,967	14.7	32.5	52.8
1997	1,162,369	11.0	31.7	57.3
1998	1,540,397	18.5	5.7	75.8

Constructed using data from Hoshi & Kashyap (2001)

Table 1 above shows the decline in IPOs and securities financing around the time of the bubble burst. At the peak of the bubble (1989), total stock financing had reached a value close to 9 trillion JPY. In comparison, after the bubble burst stock financing declined to a low of about 420 billion JPY.

TABLE 2: SECURITY FINANCING BY JAPANESE LISTED FIRMS (1972- 1998)

Year	Total (million yen)	Distribution (%)		Foreign Bonds	
		Stock	Bonds	as % of total	as % of total bonds
1972	1,784,689	58.4	41.6	0.0	0.0
1973	2,240,766	41.9	58.1	0.1	0.2
1974	1,741,396	31.2	68.8	3.4	4.9
1975	3,187,449	31.4	68.6	11.7	17.0
1976	2,302,001	29.9	70.1	18.1	25.8
1977	2,543,740	36.3	63.7	14.7	23.1
1978	2,972,270	30.2	69.8	16.4	23.5
1979	3,298,028	28.9	71.1	24.0	33.8
1980	2,883,285	36.5	63.5	24.1	37.9
1981	4,400,028	43.8	56.2	19.8	35.2
1982	4,084,502	33.0	67.0	27.7	41.3
1983	4,084,420	19.8	80.2	44.8	55.9
1984	5,409,408	19.3	80.7	44.0	54.5
1985	6,890,503	12.5	87.5	51.0	58.2
1986	8,395,196	10.4	89.6	48.2	53.8
1987	14,455,291	20.8	79.2	39.9	46.6
1988	17,636,098	27.1	72.9	30.5	41.9
1989	28,410,407	31.1	68.9	41.4	60.0
1990	14,441,448	26.3	73.7	35.8	48.5
1991	12,500,454	6.5	93.5	63.5	67.9
1992	9,619,910	4.4	95.6	60.2	62.9
1993	11,143,567	7.4	92.6	45.0	48.6
1994	8,499,604	11.0	89.0	22.6	25.4
1995	8,094,650	7.9	92.1	23.2	25.1
1996	13,616,878	15.2	84.8	18.3	21.6
1997	10,162,545	11.4	88.6	23.4	26.4
1998	15,906,750	9.7	90.3	10.0	11.1

Constructed using data from Hoshi & Kashyap (2001)

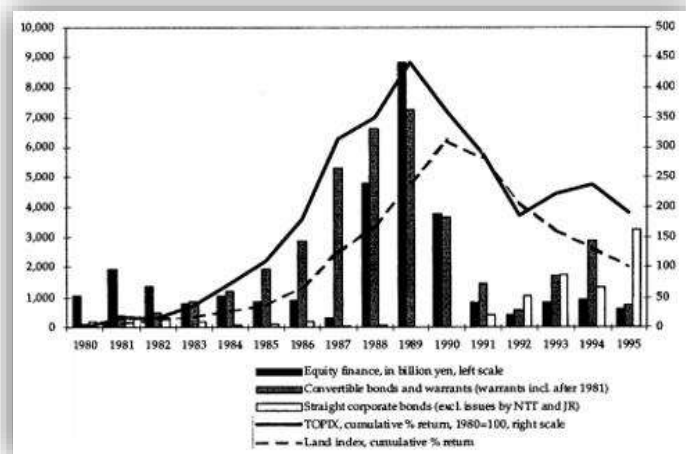
Table 2 above shows that the overall security financing was at its highest at the peak of the bubble (28.4 trillion JPY) but reached a low of 9.6 trillion JPY in 1992 at the bottom of the market following the big burst. Only 4.4% of overall security financing was stocks. On the other hand, there was an increase in bond financing which reached a peak of 95.6% of total security financing in 1992. This is in line with widely acknowledged evidence that during bear markets investors in general turn away from risky assets (e.g. stocks) to less risky investments (e.g. bonds).

Foreign investors on the go

At the top of the asset price bubble in 1989, corporate bonds issued on the international market made up 41.4% of total securities financing and 60% of total bonds. Instead, at the time of the bubble burst, foreign acquired bonds increased to 63.5% of total security financing and 67.9% of the total value of

bonds issued. But starting from 1992 international investors disinvested even from the corporate bond market leaving Japan on its own.

FIGURE 12: ASSET VALUATIONS AND CORPORATE FINANCING



Notes: This figure plots cumulative returns on the Tokyo Stock Price Index, cumulative returns on the Land Price Index, and new security issues during the 1980-95 period. The data on new security issues represent aggregate numbers for all stock-exchange-listed firms and are obtained from the Tokyo Stock Exchange Fact Book. The Land Price Index is based on urban land prices of Japan's six largest cities (the index is produced by the Japan Real Estate Institute).

Real estate and equity markets: Summary

Japan's is still the undisputed #1 bubble in history, as highlighted in a recent Japan Times' article. The chart above (Figure 12) shows the sharp rise in equity financing up to 1989. At the peak of the bubble Japan's stock market capitalization was bigger than the US, despite the economy being less than half in size, and about 45% of the global capitalization (US 33% and UK about 8%).

In the post-bubble period, equity financing and convertible bonds decreased drastically. From 1991 on, financing from straight corporate bonds increased gradually. Stock market returns -measured by the TOPIX- reached a peak in 1989 and began to decline after the asset prices bubble burst. The chart shows a marked lag in the land price index in response to the inflated asset prices compared to the stock price index. Interestingly the land price index reached a peak in 1990 and started to decline thereafter, reacting slower to the bubble burst.

FIGURE 13: JAPANESE ASSET PRICE COLLAPSE AFTER 1990

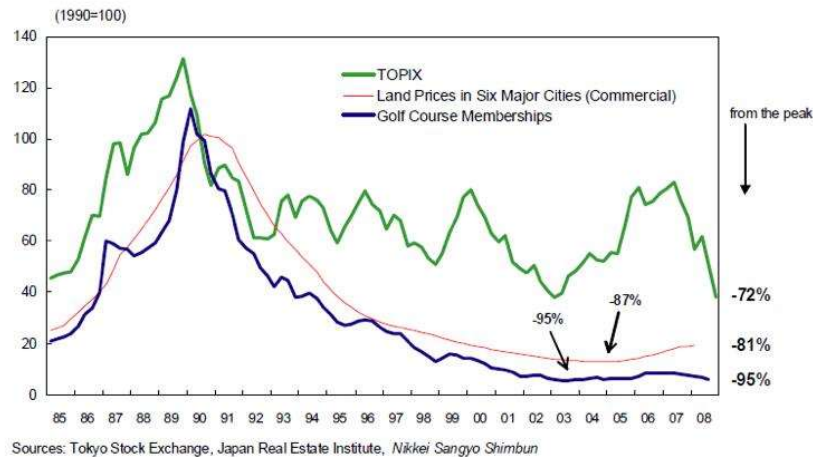
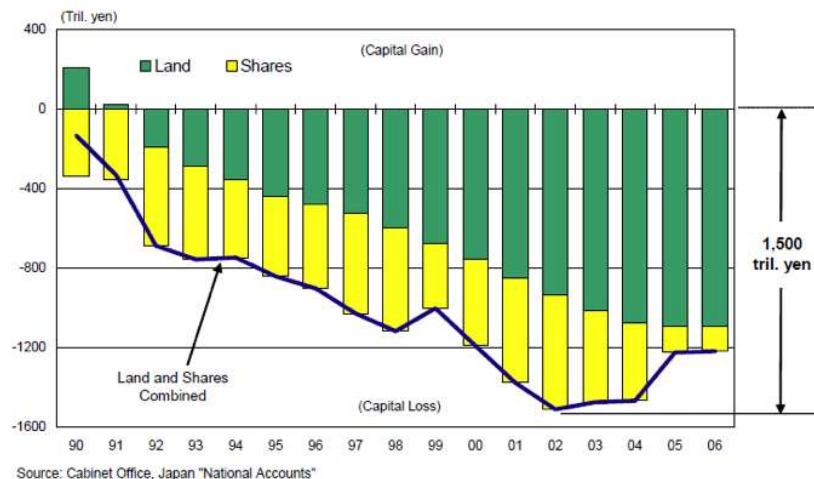


FIGURE 14: CUMULATIVE CAPITAL LOSSES -LAND AND SHARES- FROM 1990 TO 2006=15 TRN US\$ OR 3x JAPAN'S GDP



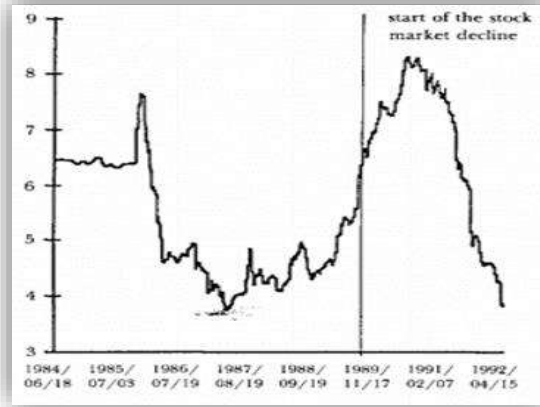
Interest rates and bubble market

The rapid movements in the stock and real estate prices can also be largely explained by the prevailing interest rate environment at the time. Following the Plaza Accord of 1985 there was a drastic decline in short-term interest rates, the result of the expansionary monetary policy implemented by the government to offset the appreciation of the JPY. Figure 15 below shows the relationship between short-term interest rates in the Japanese economy and the stock market. Stock prices were highest during 1986 when the short-term interest rates were at their lowest.

As interest rates increased at the start of the 1990s due to a tightening monetary policy, stock prices began to plunge. There was increased selling pressure, which forced most of the market participants, highly leveraged in stocks, into financial turmoil. Even when interest rates, both short and long term,

returned to low levels following a supportive monetary policy post crisis, asset prices still remained low for a while.

FIGURE 15: SHORT-TERM INTEREST RATES IN JAPAN, (JUNE 18, 1984- AUGUST 12, 1992, %)



Source: Nikkei Needs

In response to the economic crisis, the Japanese monetary policy therefore eased again. The overnight call money interest rate declined from a peak of 8.2% in March 1991 to 2% in March 1995 and declined further to 0.5% by October 1995. After the beginning of 1995, zero or negative inflation rates largely undermined the effectiveness of the monetary policy by limiting the extent to which the real interest rate could be lowered (refer to figure 23 and 24). Over the same period, the yield on 10-year government bonds dropped from 6.75% to about 3 percent.

Collapsing markets, collapsing economy

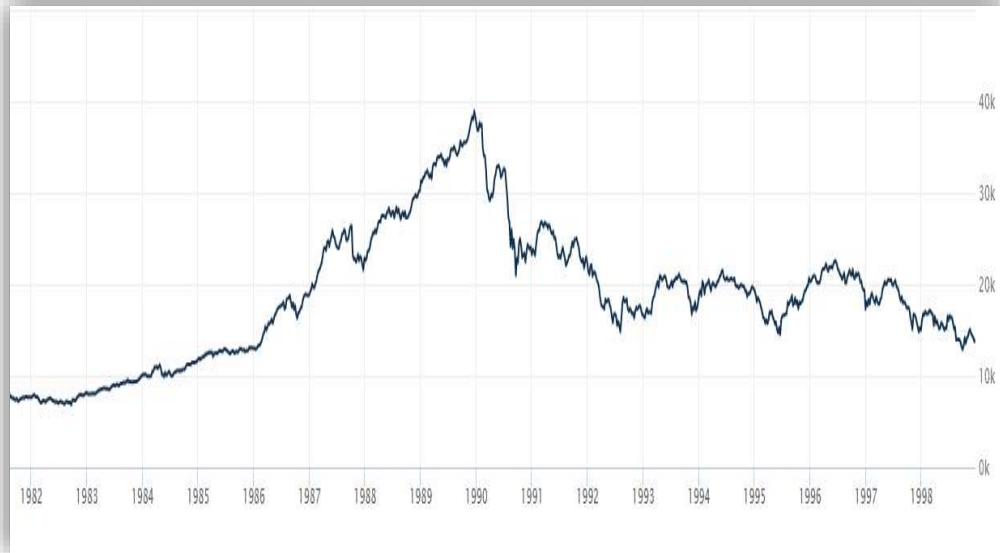
collapsing markets

The most rapid rise amongst assets was led by equities and equity prices rose rapidly due to their high volatility compared to land prices. Nikkei 225 began accelerating in 1986 and by the end of 1989 the index hit a peak of 38,915 marks, 3.1 times higher than the level at the time of the Plaza Accord in September 1985 (12,598). TOPIX increased from 1,324 in early 1987 to 2,569 at the beginning of 1990.

After the burst Nikkei 225 dropped sharply to 14,309 in August 1992, more than 60% below the peak and the TOPIX dropped almost 40% in one year from its peak. This event will be remembered together with other great market falls as the Great Depression crash (1929) which saw the US stock market declining by 87%; the Hong Kong stock market by 92% in the early 1970s; the Mexican stock market

by 78% in 1981 and the Taiwanese stock market by 80% in 1990. Figure 7 below shows the rise and fall of the Nikkei 225 from 1982 to 1999.

FIGURE 16: AVERAGE NIKKEI 225 ANNUAL CLOSING PRICE (1982- 1999)



Source: <https://www.wsj.com/market-data/quotes/index/JP/XTKS/NIK/advanced-chart>

collapsing markets: an international comparison

The decline in Japanese stock prices greatly reduced the overall market capitalisation, which fell below its global share of economic activity (% of global GDP), destroying huge wealth (see figure 14, page 39). Figure 17 below shows a comparison of the Japanese stock index against other global indexes and depicts the widening gap between Japanese and international stocks from late 1991 to 1999.

FIGURE 17: INTERNATIONAL COMPARISON OF STOCK PRICE MOVEMENTS

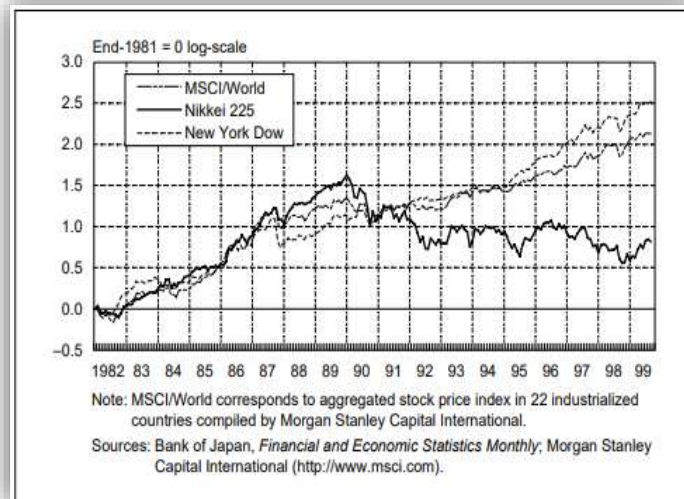
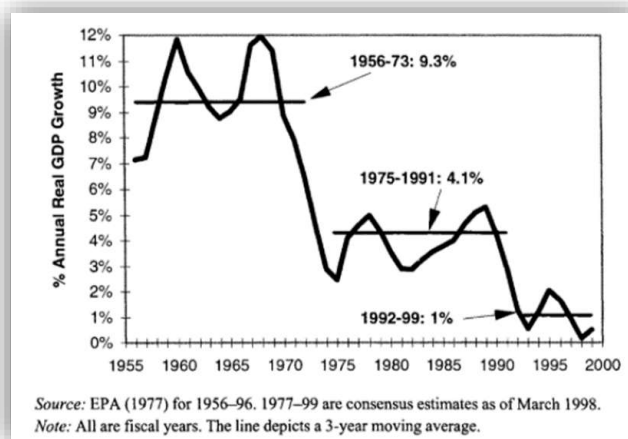


Figure 17 shows interestingly how the Nikkei 225 moved alongside other global stock market indices. Between 1982 to 1984 the Nikkei 225 index was not too far from the MSCI World and the Dow Jones average. Between 1985 and 1987 when Japanese stock prices began to rise sky-rocketing, Nikkei 225 was slightly above the other two indices. From 1987 to 1989, the Nikkei 225 rose way past the MSCI World and the New York Dow driven by the soaring stock market. In 1990 the Japanese stock market collapsed as the asset price bubble burst; the Nikkei 225 declined sharply. From 1991 the Nikkei continued to decline falling way below the other global indices. The gap between the two global indices and the Nikkei 225 kept widening for over a decade, known as the “first lost decade” (1991-1999).

collapsing economy

the impact of the financial bubble on the Japanese economy was enormous; Figure 9 below shows the decline in the Japanese economy in the post bubble period from 1990 onwards compared to previous years. Annual Real GDP growth rate dropped from a high 3-year moving average of 4.1% in previous years (1975-1991) to a low of 1% during the bear market of 1992-1999.

FIGURE 18: JAPAN ECONOMY, ANNUAL REAL GDP GROWTH, % (1955-2000)



Conclusions: the bubble economy

Figure 18 above is significant in showing the 3 main historical frames of Japan's economy after World War II, as highlighted in the chapters before. As real GDP growth represents the health of an economy, in the miracle economy is shown that the 3-years moving average of real GDP reached an exceptional overall 9.3%, with single-year unadjusted peaks of 12% during the considered time range. As already seen, in the following time range, 1975-1991, comprising the bubble economy, the 3-years moving average of real GDP showed a good 4.1% with single-year peaks of over 5%. The impact of the bubble burst pushed in the following years, the lost decade, the average GDP to an overall bearish 1%.

The main drivers of this drop in economic conditions were not only lost profits on the securities and real estate markets, but the banking sector on top of others. Banks had to take into account the huge losses on non-performing assets and the former easy and superficial lending policy was abruptly reversed. The tightening of financing of personal consumption and investments for middle and small business meant recession, as will be presented in the next chapter.

The following years, up to date, will be described as highly relevant, because the government tried several times using various means to stimulate the economy in order to compensate for the 80s financial disaster. The dramatic effects of the bubble burst introduced a full stop in the economic history of Japan so that one can speak of a pre and post bubble economy. The following chapters are dedicated to the post bubble economy showing 3 main frames, the first lost decade, the second lost decade and the years up to date (Abenomics and beyond).

CHAPTER THREE: THE FIRST LOST DECADE

The First Lost Decade (1991-2000)

Bubble Burst

Tightening monetary policy and property financing regulation

As a measure of control for the asset price inflation, the Bank of Japan (BOJ) tightened its monetary policy starting in 1989 and began to increase the interest rate. By August 1990, the interest rate had risen to over 7%, peaking at 8.2% in 1991. The JPY began to revalue. The JPY appreciation was followed straight away by a decline in stock markets, a sell-off in bonds and a further decline in stock prices. Furthermore, the Ministry of Finance (MOF) began to closely regulate property financing loans. These economic key-drivers –tightening monetary policy and conservative regulation on property financing loans- led to a drop in overall asset prices including land and property and to the subsequent burst of the asset price bubble.

Several financial institutions and property companies (leasing companies, housing financing companies and consumer and business financing companies) defaulted. The collapse of the real estate and financial markets together with the tightening of monetary policy impacted the overall national economy. As consumption and investments decreased, the Japanese economy collapsed.

Paving the way to the banking crisis

Commercial banks: stock holdings and non-performing loans

The worsening of the Japanese economy put commercial banks under great pressure too. Compared to the US and UK, since World War II banks in Japan played a crucial role in the financial system as they were historically core providers of business loans to big groups as well as to small and medium size companies (as mentioned in paragraphs “the humiliation” and “the miracle economy”).

With the financial bubble burst, banks were greatly exposed in two main ways to a decline in capital:

1) devaluation of collaterals and non-performing loans in the balance sheet. During the bubble economy banks provided asset-backed loans where the assets used as collateral were mostly land, valued at bubble price. Following the bubble burst and the subsequent decline of land prices, many

banks found themselves in a liquidity trap with large portfolios of non-performing loans and bad debts with collaterals valued at a small fraction of the original valuation.

2) devaluation of shares from positions held in industrial companies (cross-shareholdings in companies in business activity within the zaibatsu and keiretsu groups). Bank capital in Japan is typically impacted by stock price changes due to these cross-shareholding positions.

Commercial banks: the tightening of consumption and small medium businesses financing

In the post bubble period Japanese banks were therefore left with a limited capability to offer new credit as they had the compelling necessity to write off bad loans and to devalue shares holdings. Due to the lack of funding private enterprises were left with a limited financial leverage to achieve efficient

Liquidity trap

A liquidity trap is described in Keynesian economics as follows: "after the rate of interest has fallen to a certain level, liquidity preference may become virtually absolute in the sense that almost everyone prefers holding cash rather than holding a debt (as financial instrument) yielding so low a rate of interest."

A liquidity trap is caused when people accumulate cash instead of investing because they expect an adverse event such as deflation, insufficient aggregate demand, or war. Among the characteristics of a liquidity trap are interest rates that are close to zero and changes in the money supply that fail to translate into changes in the price level (inflation).

production and to support domestic economic growth. The lending constraints faced by banks implied at first under-investment in Japanese companies, particularly smaller businesses. Smaller companies had to reorganise to save cash to survive and therefore to cut or postpone planned investments.

Figure 10 below shows the percentage change in bank credit availability, which is tightly related to interest rates. It highlights a steady access to credit between early 1989 to mid-1990 and thereafter a sharp decline in credit availability. From 1994 there is a very slight increase in bank lending which decreases again from late 1998.

A non-responsive monetary policy

Starting from 1991 the Japanese government implemented in several steps an expansive monetary policy to sustain the collapsing economy. This monetary policy was, at a certain point and after an apparent recovery, substantially unable to stimulate the economy.

The step-by-step interest rates adjustments led finally to a non-responsive monetary policy.

Conclusions: bubble burst and paving the way to the banking crisis

The 1989-1990 tightening monetary policy to control inflation together with the regulation limiting access to property financing led to the bubble burst, the banking crisis and economic recession.

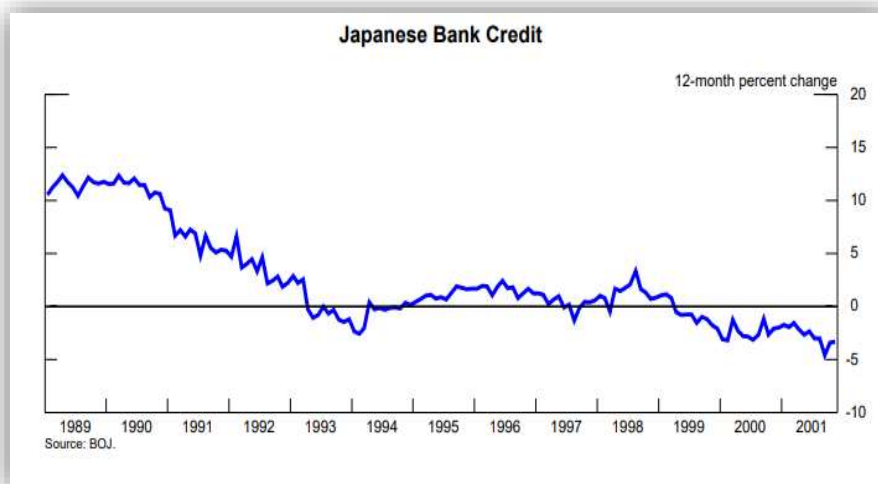
Banks were left with reduced capital due to non-performing loans and due to the devaluation of stock holdings.

The suffering of banks implied the decline of credit financing of consumption and small-medium business activity.

Households and businesses developed a risk-averse investment attitude (cash savings).

Starting from 1991 the monetary intervention of cutting interests to offset recession led to a non-responsive monetary policy.

FIGURE 19 : JAPANESE BANK CREDIT (1989- 2001)

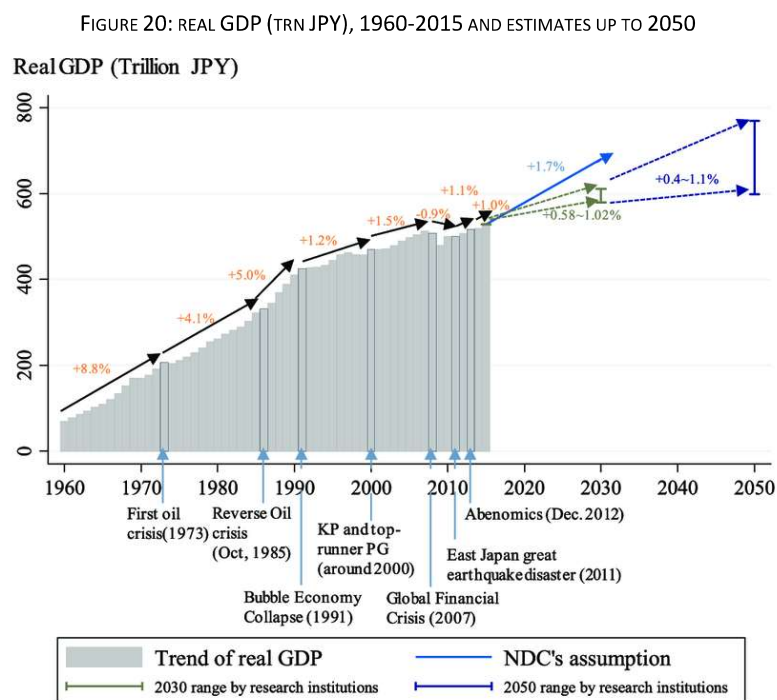


• First Adjustment (1991-1996)

Stimulative monetary and fiscal policy

In the mid-1990s the Japanese economy saw an initial recovery backed by various stimuli such as the easing of monetary policy as described above. Following the fiscal and monetary policy adjustments in the early 1990s, the nation began to see a glimpse of hope as the economy went through a steady recovery period. By the end of 1996, the economy had grown by 5%. In reality this was only a supported artificial growth, and it didn't last long.

In May 1994, the BOJ observed in its Quarterly Bulletin (pp. 32-33) that "Japan's economic growth appears to have stopped weakening, against the background of progress in capital stock adjustment as well as the permeation of stimulative effects of monetary and fiscal policies to date." By November, the BOJ noted that the economy was "recovering gradually," with all categories of spending showing strength, and long-term interest rates increasing accordingly in apparent response.



Can Japan enhance its 2030 greenhouse gas emission reduction targets? Assessment of economic and energy-related assumptions in Japan's NDC - Scientific Figure on ResearchGate. Available from: https://www.researchgate.net/figure/Real-GDP-in-Japan-historical-trend-1960-2015-and-the-future-levels-estimated-from-2030_fig4_333421417

FIGURE 21: REAL GDP 1995-2021



The earthquake, JPY appreciation and stock market turmoil

This initial recovery, however, has been limited by another shock and wave of turmoil:

the shock was caused by the Great Hanshin/ Kobe earthquake of 1995 that badly hit parts of South Japan. It followed an appreciation of the JPY and another sharp decline in stock prices.

The decline in stock prices has been attributed at the time to investors switching their investments from equities to low-risk government bonds expecting a downward spiralling economic trend, which indeed took place.

FIGURE 22 : DAMAGED KOBE ROUTE OF THE HANSHIN EXPRESS WAY



Source: National Geographic

The BOJ responded to the economic downturn by reducing the interest rate by 75 basis points in April 1995 and a further 50 basis points in the third quarter of 1995, bringing the official interest rate to 0.5% by the end of the last quarter of 1995. This was globally an unprecedented low interest rate considering that 1% had been the lowest rate experienced by any industrialised country so far (USA reached 1% interest rates in the 1930s and Switzerland in the 1970s).

FIGURE 23: JAPANESE NOMINAL INTEREST RATES 1970-2021



- Second Adjustment and the banking crisis (1997-1999)

Fiscal stimulus and recession

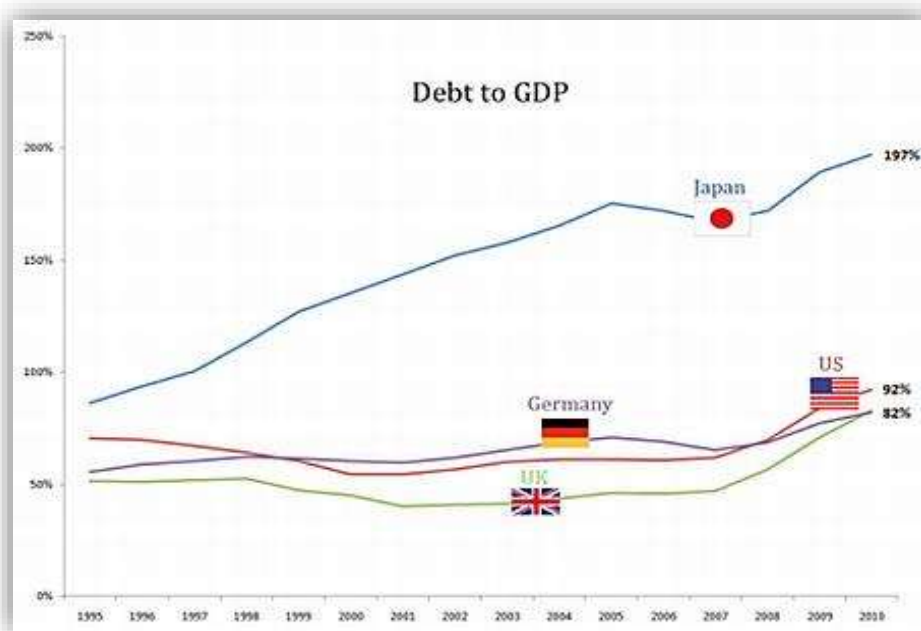
By the end of 1997 the Japanese economy had begun to suffer again, and the nation entered one of its worst ever recessions in the post-war period triggered by the financial crisis. The recession continued into 1998. To stimulate the economy, the government approved a fiscal stimulus mainly through public investment spending, leading to a much higher public debt bill. In November 1998 Moody's downgraded the Japanese sovereign debt. Despite the downgrade, the fiscal stimulus seemed to have boosted the economy and, by the end of 1999, Japan began to see a renewed recovery supported by the increased public spending.

Figure 24: Japan government public debt as % of GDP



Source: IMF Data mapper

Figure 25 : debt to GDP ratio, Japan in comparison to other developed countries (1995- 2010)



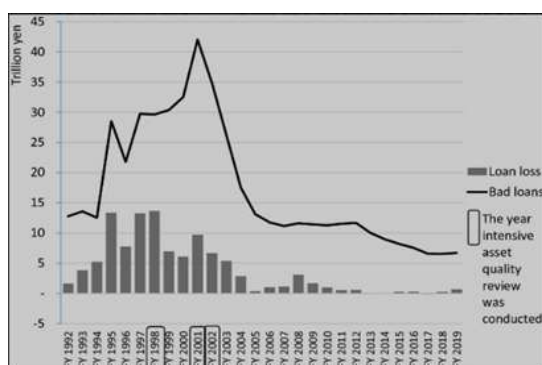
Source: Japan Ministry of Finance

The multiple short-term recoveries of the Japanese economy have been linked to the unwillingness to tackle the dire financial situation of the country.

The banking system crisis*

*We thank Ryoza Himino for the outstanding and original coverage the banking crisis in the book "THE JAPANESE BANKING CRISIS" (2020), from which we significantly relied upon in this part of the research

The failed attempt to hide the crisis



The prolonged recession period was caused by the problems existing within the Japanese banking system, which started at the time of the bubble burst (1990-1991). As it is the case in every financial crisis, the cause of the banking crisis in Japan was the real estate and the equity bubbles that led the accumulation of non-performing loans (NPLs). The

massive cross-shareholdings between banks and clients compounded further the issue. As shown in the above figure, the total amount of non-performing loans at the end of fiscal year 1995 increased more than 70% from the previous year to about 27 trillion JPY for major banks (city, long-term credit and trust banks) and 28.5 trillion JPY for all banks (not including cooperative financial institutions). Historically the period between the collapse of real asset bubbles and a banking crisis is less than two

years in most of the cases. It lasted seven years in Japan. In fact, the Japanese authorities (Finance Ministry) chose in 1992 to rely on banks' multi-year profits to resolve the bad loans rather than clean them up immediately. Pushing the issue down the road protects the country's structure and avoid unintended consequences but penalizes long-term economy and the working class.

In 1992 the Regulator published the amount of net loans in arrears held by 21 major banks. It was estimated being 3 trillion Yen, equal to 3 years of profit of the sector. Apparently small beer. Actually, the analysis was biased, and rumours go that privately the Ministry of Finance and the BoJ reckoned the amount being between 10 and 15 times bigger, as included the non-banking lenders and the massive amount of extended credits, a classical way to disguise NPL. At the end the total losses turned out being more than 88 trillion of Yen, about 20% of the Japanese GDP at that time. In 1992 the total size of the banking sector's own capital was just 30 trillion yen...

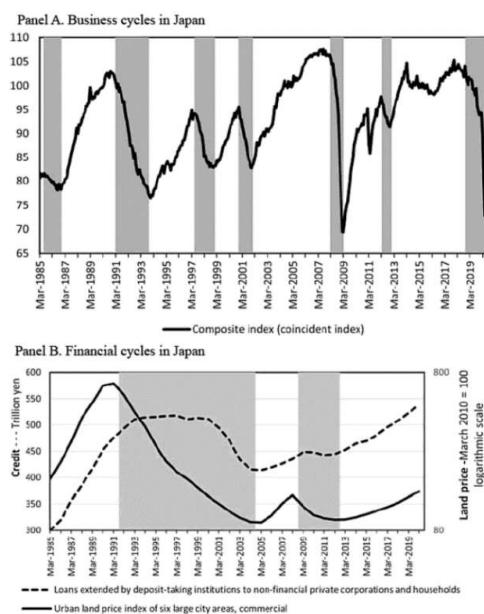


Fig. 1.2 Business cycles and financial cycles in Japan (Note The unshaded areas indicate upturns and the shaded areas represent downturns. Source Cabinet Office, The Reference Dates of Business Cycle, and Index of Business Conditions; Bank of Japan, Flow of Funds Accounts Statistics; and Japan Real Estate Institute, Urban Land Price Index)

The previous figure shows the gradual rise again in non-performing loans in trillion JPY from March 1999 to March 2001, reaching a peak in March 2002 at 47 trillion Yen.

Government's delayed intervention

As mentioned, the "lost decade" was prolonged due to the delay by the Japanese government in addressing the problem of the banks' accumulated bad debts and non-performing loans. The equity and land prices bubble started collapsing in 1990-91 and financial institutions started to fail in 1992, but it was only in 1995 that the government responded with a

nationwide bank bailout plan.

First, to resolve the bad loans, banks need to foreclose the borrowers and sell collaterals, making the land price decline further. Lower land price, however, increases bad loans and reduces the value of real estate collaterals.

Second, bad loans were not the only source of vulnerability on the Japanese banks' balance sheet. Japanese banks had large cross-shareholding with their customers. According to the simulation by the Ministry of Finance in the summer of 1992, if the Nikkei stock index had broken the 12,000 yen line, some banks would be in negative net worth, and if it had fallen below 10,000 yen, large number of

banks, even without recognizing losses on bad loans. The Nikkei index, which reached 38,915 yen at the end of 1989, recorded 14,194 yen on August 19, 1992, drawing near the red line.

Here comes the third and the most important dilemma. The regulators needed public support for new resolution powers and an enormous amount of funding to avoid a systemic crisis. The series of bankers' scandals revealed in 1991 were surely not helpful in securing such support. Most likely, such political support can be acquired only after a systemic crisis. Of course, regulators could have tried to convince the public that the amount of money was truly needed to avoid a catastrophe, but depositors' confidence in the banking system would then be lost halfway through the persuasion and a catastrophe would be triggered before the law were approved. This was something already happened in the country in 1927, during the "Showa financial crisis", case that was well studied by the ministry of Finance at the time.

An editorial which appeared on the Nikkei newspaper on May 29, 1992 describes a supervisory practice at the time: "Every year in April or in May, meetings are informally held at the Banking Bureau of the Ministry of Finance to give bankers administrative guidance how banks should account and publish the financial results for the accounting year ended in March. We see a few bankers sit in front of the desk of the Director, and the conversation there de facto determines how the bank will report its annual financial results." And then the editorial goes on "One can guess what was written in the clinical chart the Ministry prepared. The patients, ailing from the aftermath of the exuberance during the bubble economy, would not survive surgeries needed to cut off the diseased organs. The only available option is non-surgical, internal therapy of taking nutrition and waiting bad blood to be gradually purified. Or more explicitly, it must be that the Ministry instructed bankers not to throw away the affiliated non-bank lenders in trouble, but to support them with forbearance in interest rate and repayment schedules and with additional lending, and to make up the costs by annual income flows".

In January 1991, the Bank's cross-department team reached a conclusion. An insolvent bank should be resolved, not by liquidation but by purchase and assumption approach (P&A), as is the case with most failed banks in the United States. The Japanese Deposit Insurance Law, after its amendments in 1986, had indeed been equipped with the approach. Depositors should be protected, but the bank's management should be replaced, and shareholders should bear losses. If needed, the Deposit Insurance Corporation should provide financial assistance to support purchase and assumption operation, and the Bank of Japan should lend necessary amount of money. But the Ministry of Finance was not supportive of the principle that an insolvent bank should be resolved. If the land price and the stock price should recover, banks with negative net worth would become solvent again. If the Bank of

Japan line of thought had prevailed, Japan would have had a systemic banking crisis in 1992 or 1993. The period between the commercial real estate price peak in 1990 and the crisis would then have been two to three years, in line with the other financial crisis. That would have been much better for the nation.

The Crisis

At the end of 1997, *Sanyo Securities*, a medium-sized broker dealer, defaulted on the loan market. Apparently, this did not create a systematic risk as the company took no deposits and its operations were straightforward. However, its default represented the first ever happened in the Japanese Interbank Market. This started to freeze up and in an already stressed environment, it triggered a chain reaction. So, few days later it was followed by bankruptcies of *Hokkaido Takushoku Bank*, one of the country's main institutions and *Yamaichi Securities*, the fourth Japanese brokerhouse. The Ministry of Finance, with the help of the Bank of Japan, found a recipient bank for the former over the weekend and the purchase and assumption was announced in the afternoon of Sunday, November 16. There was no resolution framework for broker-dealers. Given that Yamaichi had a big derivatives book and significant cross-border exposures, the *Bank of Japan* decided to provide uncollateralized liquidity support. On November 24, Yamaichi announced that it will wind itself down. No depositors or creditors suffered loss except for creditors to *Sanyo Securities*. Nevertheless, the succession of big-name resolutions shocked the nation. In addition, the *Deposit Insurance Corporation* had already run out of its policy reserve by March 1997 and the size of financial assistance needed to achieve the purchase and assumption transaction for the *Hokkaido Takushoku Bank*, four times as large as the annual premium, was far beyond its financial resources.

On November 25, 1997, due to an unfounded rumour, queues were formed at branches of one regional bank. Early in the morning of November 26, the resolution of another regional bank through purchase and assumption was announced. The crisis had unfolded.

According to Hiroshi Nakaso, who then was the director in charge of financial stability at the Bank of Japan, "This was probably the day that Japan's financial system was closest to a systemic collapse."

The Bank of Japan dispatched enormous amount of cash, since depositors would panic if a branch should run out of cash. In the evening of the day, the minister of finance and the governor of the Bank of Japan issued a joint statement confirming that deposits and interbank exposures would be protected. The heads of the local branches of the Ministry and the Bank in the affected regions held joint press conferences to calm the depositors. Banks showed video-taped press conferences at

branches. TV stations refrained from broadcasting the queues and newspapers refrained to report. There were no social networking services in those days. The queues subsided in the following days.



A long line of customers in front of the Shinjuku Branch of Yamaichi Securities in Tokyo on November 25, 1997

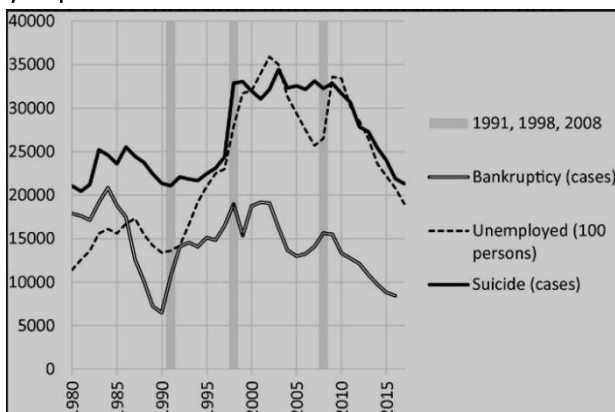
The ruling party, LDP, agreed in December to guarantee the borrowing by the Deposit Insurance Corporation and provides funds to it. The money could be used both for assisting purchasers of failed banks and

for supporting living banks. The amount

of money was increased to thirty trillion yen. The Diet passed the new laws on February 1998. While the idea of using public funds to save the banking system was earlier unpopular with the public opinion, now it was the favoured option. The nation could now accept the use of public funds after a financial crisis became a reality and the economy was brought to the brink of a panic.

However, it was far from over. A bribing scandal erupted that affected the Ministry of Finance and the BoJ creating confusion and slowing down the process. The Asian crisis, the VAT raise and the credit crunch following the banking crisis, threw Japan in recession in 1998 and 1999.

The Bank of Japan then entered the brave new world of the unconventional monetary policy. It introduced the world's first zero interest rate policy (ZIRP) in March 1999. In April it announced that it would continue ZIRP till the deflationary concern was dispelled, introducing the world's first forward guidance. The 10-year JGB rate declined to 1.3% in May and the yen depreciated to the level of 120 yen per dollar.



The crisis was contained with massive capital injections in banks, much-enhanced resolution tools, stronger disclosure and provisioning, and the new supervisory agency. The crisis, however, resulted in credit crunch, recession, bankruptcy, unemployment, and suicide and left deep scars in the Japanese economy and society.

By the end of March 1999, major banks had been recapitalized, and the safety net had been much strengthened. Bad loans were better provisioned against, and the regulator was revamped. With

these, the systemic meltdown was averted, but the Japanese banking system had a long way to go before recovering completely. Meanwhile the economy started to recover in 1999.

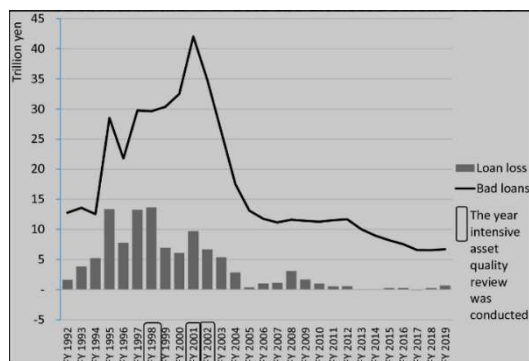
Every year, banks declared that they thoroughly looked at bad loans and disclosed them all, but they had to report much more in the following year. Market participants suspected that regulators and bankers were hiding more problems. By summer 1999, it was widely recognized that cleaning up of bank and borrower balance sheets were needed to sever the vicious cycle and reactivate the economy. The cleaning up, however, was never easy. The JFSA tightened the standards, set new targets, repeated intensive on-site inspections, improved the mechanisms for borrower restructuring, and resolved numerous banks. But it took five more painful years to finally clean up the problem.

To put an end to the problem, the economic policy package published by the government in April 2001 requested banks to remove existing bad loans from their balance sheets within two years and new bad loans within three years ("2-year and" "3-year rule").

On the other hand, **the short economic recovery came to an end by September 2001**. The GDP growth rate of the second quarter of 2001, published in September, turned negative. Nikkei Stock Price Index, which had been above 20,000 yen in March 2000, fell below 10,000 yen. Confidence in the banking system was particularly impaired when a large supermarket group failed in September 2001. Bonds issued by the group had traded much below par, but banks had not classified loans to the group as doubtful. This incident strengthened market participants' suspicion that banks hid large amount of doubtful loans.

Responding to this, in the economic policy package in October 2001, the government declared that the bad loan problem shall be rectified within three years and announced that the JFSA would conduct a Special Inspection that focused on loans to large borrowers on which the capital market was signalling doubts. This second wave of asset quality review was conducted between October 2001 and April 2002. In ordinary inspections, inspectors review bankers' assessments of the loan book after the annual financial statements are published. In this case, inspectors discussed with major banks how their loans should be classified in the financial statements for the fiscal year 2001 in March 2002.

As shown in chart here below, both the disclosed amount of bad loans and the credit losses recognized by banks jumped up in March 2002. Further, the JFSA in April 2002 requested major banks to eliminate



50% of doubtful loans from their balance sheet within a year from the time classified as doubtful and 80% within two years ("50% and 80% rule"). Combined with the "2-year and 3-year rule," the outstanding amount of bad loans should start to decline.

But the new prime minister, Junichiro Koizumi could not wait to see if these policies would work as envisaged. He replaced the minister for financial services in September 2002. The new minister, Takenaka Heizo, openly denied the approach adopted by his predecessor, Yanagisawa Hakuo, who directed the Focused Inspection in 1998 and the Special Inspection in 2001. Responding to the criticism that his policy would lead to a hard-landing rather than a soft-landing, Takenaka (2008) argued "the policies taken so far have been 'never-landing' (i.e. never arriving at a solution), and those would lead in the long run to a "crush lending". In his view, the JFSA "was paralyzed by a sort of functional failure" and the JFSA bureaucrats "were prisoners of the idea of bureaucratic infallibility (the public demonstration of an attitude implying that all the policies adopted so far have been impeccable)."

One month after taking office, Minister Takenaka and his team published a new policy package. The package set the goal of cutting major banks' bad loan ratio by half by March 2005. To attain the goal, the package announced that (i) the discount cash flow approach shall be used in provisioning against doubtful loans, (ii) inspectors shall require major banks to adopt consistent classifications of large problem borrowers, and (iii) the JFSA shall disclose the aggregate amount of gaps between bankers' own assessment and inspectors' review and issue administrative sanctions on banks if the gap persists unreasonably. With these sticks in hands, the JFSA inspectors conducted another round of Special Inspection from January to April 2003.

While waiting for the outcome of the Special Inspection, the whole Japanese economy was in suspense. As the 50–80% rule introduced by the former minister Yanagisawa was still alive, majority of the borrowers newly classified as doubtful had to be restructured or resolved within a year or two. **Speculations on imminent bankruptcies of large zombie firms were hazarded, and, on April 28, 2003, the Nikkei Stock Price Index hit the record low of 7604 yen, the level almost half of the bottom seen during the 1998 crisis.** Some also speculated that some of the major banks may turn insolvent. The fear of another systemic crisis prevailed.

However, banks' annual reports published by the end of May 2003 showed that, despite the enhanced scrutiny, the amount of bad loans declined. The amount of credit losses, measured using the discount cash flow approach, was also lower. In other words, this round of Special Inspection underscored that the preceding round had already properly identified bad loans and loan losses. At the same time, the new minister's highly confrontational discourse worked to convince the market that no forbearance was exercised and gave strong credibility to this outcome. The capital adequacy of one major bank, Resona Bank, dipped below the regulatory minimum, but, as described below, the government gave a precautionary capital injection, avoiding wipe-off of the shareholders' rights and dissipating the fear of another systemic crisis.

Stock prices were reversed. An economic boom started in the United States gave the Japanese economy a long-awaited stimulus. The real GDP, which was almost flat in 2001 and 2002, resumed growth at an annual rate of around 2%. The bad loan ratio of major banks continued to decline from 8.4% in March 2002 and reached 2.9% in March 2005, overachieving the goal of halving, and stayed at the low level since then. In FY 2005, the Japanese banks incurred almost no credit losses in aggregate. **The six large city commercial land price index, which had continued to decline for 15 years, started to pick up in March 2005.**

During this financial cycle, 181 banks, Shinkin banks, and credit cooperatives were resolved. Of which, 63 were resolved before the full sets of resolution tools were installed in October 1998.

Meanwhile a decade from the financial bubble had passed and no real economic recovery really had taken place.

Value of loans purchased, purchase price, and purchase price in % of value

	2000	2001	2002	2003
Value of loans purchased (billion yen)	451.0	522.2	330.2	2 088.5
Purchase price (billion yen)	21.7	12.6	20.6	205.7
Purchase price percent of value	4.8%	2.4%	6.2%	9.8%

Source: Deposit Insurance Corporation of Japan website: www.dic.go.jp/index.html in Anderson (2004)

Bank losses from NPLs (1992-2002)

100 million yen

	FY1992	FY1993	FY1994	FY1995	FY1996	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002
Total Losses on Disposal of Non-Performing Loans	16,398	38,722	52,322	133,692 (110,669)	77,634 (62,099)	132,583 (108,188)	136,309 (104,403)	69,441 (53,975)	61,076 (42,898)	97,221 (77,212)	66,584 (51,048)
Net Transfer to provisions for Loan Losses	9,449	11,461	14,021	70,873 (55,758)	34,473 (25,342)	84,025 (65,522)	81,181 (54,901)	25,313 (13,388)	27,319 (13,706)	51,959 (38,062)	31,011 (20,418)
Direct Write-offs	4,235	20,900	28,085	59,802 (54,901)	43,158 (36,756)	39,927 (35,005)	47,093 (42,677)	38,646 (36,094)	30,717 (26,500)	39,745 (34,136)	35,201 (30,376)
Write-offs of Loans	2,044	2,354	7,060	17,213 (15,676)	9,730 (8,495)	8,506 (7,912)	23,772 (22,549)	18,807 (17,335)	25,202 (22,014)	32,042 (27,183)	21,627 (17,737)
Losses on Sales through Bulk Sales, etc.	2,191	18,546	21,025	42,589 (39,225)	33,428 (28,261)	31,421 (27,093)	23,321 (20,128)	19,839 (18,759)	5,516 (4,486)	7,703 (6,953)	13,574 (12,640)
Others	2,714	6,361	10,216	3,017 (10)	3 (1)	8,631 (7,661)	8,035 (6,825)	5,482 (4,493)	3,040 (2,691)	5,517 (5,013)	372 (253)
Cumulative Total since FY 1992	16,398	55,120	107,442	241,134 (218,111)	318,768 (280,210)	451,351 (388,398)	587,660 (492,801)	657,101 (546,776)	718,177 (589,674)	815,398 (666,886)	881,982 (717,934)
Cumulative Total of Direct Write-offs	4,235	25,135	53,220	113,022 (108,121)	156,180 (144,877)	196,107 (179,882)	243,200 (222,559)	281,846 (258,653)	312,563 (285,153)	352,308 (319,289)	387,509 (349,665)
Risk Management Loans	127,746	135,759	125,462	285,043 (218,682)	217,890 (164,406)	297,580 (219,780)	296,270 (202,500)	303,660 (197,720)	325,150 (192,810)	420,280 (276,260)	348,490 (204,330)
Provisions for Loan Losses	36,983	45,468	55,364	132,930 (103,450)	123,340 (93,880)	178,150 (136,010)	147,970 (92,580)	122,300 (76,780)	115,550 (69,390)	133,530 (86,570)	125,850 (78,970)

Data FSA Japan

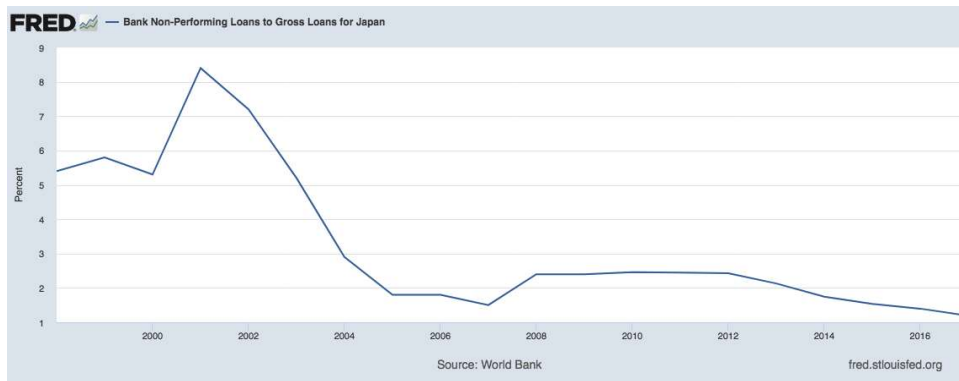
Bank losses from NPLs after Financial Reconstruction Law FRL (1998-2002)

100 million yen

		FY1998	FY1999	FY2000	FY2001	FY2002
City Banks, Long-term Credit Banks and Trust Banks	NPLs based on the FRL	219,450 (219,450)	203,580 (184,930)	200,080 (180,320)	283,850 (267,820)	206,800 (202,440)
	Bankrupt or <i>De facto</i> Bankrupt	53,660 (53,660)	40,800 (37,910)	36,970 (31,800)	35,290 (32,010)	22,100 (21,610)
	Doubtful	123,180 (123,180)	108,400 (100,660)	91,700 (84,850)	129,790 (122,330)	67,740 (65,820)
	Specical Attention	42,610 (42,610)	54,380 (46,370)	71,410 (63,670)	118,770 (113,480)	116,960 (115,010)
Regional Banks & Regional Banks II	NPLs based on the FRL	119,980	114,470	136,220	148,220	146,600
	Bankrupt or <i>De facto</i> Bankrupt	49,550	37,060	39,640	38,750	35,370
	Doubtful	50,970	54,080	58,640	63,360	62,390
	Specical Attention	19,460	23,330	37,940	46,110	48,840
All Banks	NPLs based on the FRL	339,430	318,050	336,300	432,070	353,390
	Bankrupt or <i>De facto</i> Bankrupt	103,210	77,860	76,610	74,040	57,470
	Doubtful	174,150	162,480	150,340	193,150	130,130
	Specical Attention	62,070	77,710	109,350	164,880	165,790
Deposit-Taking Financial Institutions	NPLs based on the FRL	425,510	409,350	429,850	524,420	445,070
	Bankrupt or <i>De facto</i> Bankrupt	142,050	112,470	110,610	103,960	87,020
	Doubtful	203,910	197,040	186,270	229,120	166,200
	Specical Attention	79,550	99,840	132,970	191,340	191,840

Data FSA Japan

FIGURE 26: NPL, % OF TOTAL LOANS



Banking crisis and impact on the corporate world

The banking crisis did not affect companies equally. It has been acknowledged that small to medium sized firms were most affected due to their lesser systemic risk in comparison to larger, more established firms. Furthermore, firms in traditional sectors such as manufacturing and construction (low tech sectors) were most affected by the limited credit financing due to their high leverage compared to firms in high-tech sectors.

Figure 30 below shows the aggregated accumulation of debt by companies in different industries. From 1986 to 1995, the amount of debt reflected on balance sheets increased by more than 100% for some industries. In construction and real estate debt increased exponentially between 1989 and 1991 and stabilized between 1991 and 1995 according to the financial bubble context.

Figure 27: Corporate Balance Sheet Trends (1986-1995)

Corporate Balance Sheet Trends (trillion yen)						
	Manufacturing			Nonmanufacturing (except construction and real estate)		
	1986	1991	1995	1986	1991	1995
Liabilities	186.1	254.1	261.9	312.2	478.7	565.5
Long-term debt + corporate bonds	47.4	79.2	84.6	93.9	163.1	208.1
Equity	69.3	115.0	127.0	52.2	89.1	95.4
Debt-to-equity ratio	68.4%	68.9%	66.6%	179.8%	183.0%	218.1%
	Construction			Real estate		
	1986	1991	1995	1986	1991	1995
Liabilities	54.7	104.9	114.4	57.6	136.3	149.6
Long-term debt + corporate bonds	8.6	19.2	24.6	20.7	59.1	63.7
Equity	10.2	19.0	25.8	5.4	9.0	5.4
Debt-to-equity ratio	84.8%	100.9%	95.3%	385.4%	655.8%	1,184.2%

Source: Economic Planning Agency. 1997. *Economic Survey of Japan, 1995-1996*, p. 92.

Conclusions: first and second adjustment, the banking system crisis

After the bubble burst in 1989 Japan had to deal with the impact of the financial turmoil generated by the bubble. It tried to intervene with monetary and fiscal policies to offset the economic recession and to support recovery (first adjustment). But the financial system was struggling with a harsh banking crisis that was addressed late by the government and the BOJ, several years after the bubble shock. The instability of the banking sector interfered with the implemented monetary and fiscal policy, which led to a gradual, slow and difficult economic recovery. In 1995 another shock hit Japan, the Great Hanshin/Kobe earthquake that pushed the Japanese economy back into recession. Through the second adjustment and an important fiscal stimulus, the Japanese economy saw a renewed recovery. But monetary and fiscal interventions alone couldn't support a real recovery until structural reforms to the financial and industrial system took place. The tackling of the banking system removed the main obstacle to the recovery of the country through the introduction of a series of reforms led by the new prime minister Junichiro Koizumi.

CHAPTER FOUR: THE SECOND LOST DECADE

The second lost decade (2001-2010)

- Koizumi and structural reforms (2001-2006)

Figure 28: Junichiro Koizumi (2001-2006)



Source: Japan times

Introduction

Junichiro Koizumi was the prime minister of Japan from 26 April 2001 to 26 September 2006. Born to a political family, his father Jun'ya Koizumi was Director General of the now Ministry of Defence and his grandfather Koizumi Matajirō was Minister of Telecommunications.

Koizumi's administration is well known for the implementation of various structural reform policies although he also benefitted of the effects of the reforms of Hashimoto administration (1996-8). The PM was a convinced supporter of deregulation, that Japan went through during his mandate. Furthermore, Koizumi

assessed the privatisation of the Postal Services Savings system, a radical move to help clearing out bad bank loans and to curb high state indebtedness. The Postal Services Saving system was effectively the world's biggest financial institution with 3 trillion US\$ in savings and insurance assets.

However, most of all Koizumi is remembered for his pro US foreign policy and the intervention into the Iraq war alongside the US.

Koizumi began his mandate when Japan was facing grave economic difficulties including:

- the bad loans problem that affected the banking sector,
- a 5.6% unemployment rate, a record high in the post-war period
- persistent deflation.

As the nation was coming out of its first lost decade, the PM was faced with the challenge of restructuring the Japanese economy. Koizumi declared to be willing to implement strong structural

reform policies driven by the slogan “reform with no sacred cows”. His focus areas for policy intervention included banks, government spending and regulatory reforms. In some instances, Koizumi faced strong opposition from his own political party, the Liberal Democratic Party (LDP). This brought about renewed elections that reappointed Koizumi with a great voting support. The Japanese people wanted Koizumi to restructure the domestic economy.

Structural reform: Act I

At the very beginning of his mandate, Koizumi's approach to reform contemplated an economic hard-landing, according to the prevalent Austrian school of economic philosophy. This school suggested that “bankruptcy and unemployment are indispensable for an economy to reinvigorate itself” (from Takemori Shumpei, Japanese identity). More specifically, structural reform was at first a hard-landing approach to the bad loans problem in the Japanese banking sector. Koizumi implemented several measures impacting banks' balance sheets, which included abolishing the generous treatment of deferred tax assets. He even tried to limit issuance of new debt to 30 trillion JPY per year starting in 2002. This naturally caused panic in the Japanese banking sector.

The stock market reaction was of course harsh: drops in stock prices, significant rises in the risk premiums of the banks' bonds and the first signs of a major economic recession, Koizumi had to rethink about his structural reform and to soften his hand.

Structural reform: Act II

In 2002 the approach to reform was actually mediated when Koizumi decided on a package of fiscal stimulus to briefly support the economy, going back to the previous (popular) methods.

He then promoted a massive 3 trillion JPY non-sterilized intervention on the currency market agreed with BOJ to prevent JPY's appreciation. Doing this he reverted the currency approach of the previous 30 years.

Another intervention was the rescue operation (followed by several others) of Resona bank, which, almost bankrupt from having negative capital, was injected with money to redeem the existent shares at the pre-crisis price. This was a market-friendly move and set this end of the banking crisis.

Structural reform: Act III

After a period of overall stabilization and recovery, in 2004 Koizumi clashed with his party, the LDP, and new elections were called. In 2005 he was reappointed after a new election. He was the strong man in power, providing hope to a downbeat population.

It was time to implement the privatisation of the Japanese Postal Services. As seen above, the Postal Service was the world's biggest financial institution worth about 3 billion US\$ in savings and insurance assets. The bill for reform was cleared by the Diet. Soon after Koizumi left office.

In 2006 Junichiro Koizumi retired as PM paving the way for the appointment of Shinzo Abe, who took office in September. Koizumi however maintained his seat in the Diet (Japanese Parliament) representing his hometown of Kanagawa until 2009, when his son Shinjiro Koizumi was elected to the same seat and replaced him. He then retired from the political scene.

- Restructuring the banking system

Koizumi, as mentioned earlier, took the helm when the restructuring of the banking system was well under way. He nonetheless:

- 1) gave credibility to the process
- 2) recreated a market friendly environment sparing the Resona shareholders from losses
- 3) privatized the gigantic postal office group of companies, the biggest financial institution in the country and a huge centre of power and bureaucracy

Koizumi's government also passed the Financial Reconstruction bill which led to the setting up of the Financial Reconstruction Commission. The measures taken to save the ailing financial system included not only loan repurchasing programs but even bank recapitalisation initiatives. The government injected public funds into banking institutions to allow them to reorganise and to offer loans again

Conclusions

Although the bad loans problem and turmoil in the financial system came to an end by 2004, the nation was stuck in the purgatory of economic stagnation. Inflation, growth rates and interest rates remained low.

Global Financial Crisis (2008)

In the third quarter of 2008, following the global financial crisis, the Japanese economy entered another recession. Despite the US being the epicentre of the crisis, Japan was hit twice as hard compared to the US economy. The economy decreased by an annualised rate of 12.1% in the fourth quarter of 2008, in comparison to the 6.2% in the US. Industrial production fell by 31% since its peak in February 2008, again far worse than the 11% drop in the US. The TOPIX stock index fell to a new post-bubble low, down 61% from its February 2007 high, and 76% from its all-time high. The S&P 500, on the other hand, fell by 57% from its September 2007 peak, which was also its all-time high.

This has been attributed to the fact that by the time the global financial crisis hit, the Japanese economy had not fully recovered from its own woes. In addition to this, there was a lag effect of the international crisis on the Japanese economy. As the global economic crisis escalated, the JPY appreciated rapidly.

The government responded by providing stimulus packages to both firms and households. Companies received financial support from the state-backed Development Bank of Japan. The BOJ injected funds into the banking system to support interbank borrowing as well as to encourage lending and asset purchases. Some Japanese banks and investment companies took advantage of this support financing to buy US stocks at discounted prices, as did for example Nomura Securities. Nomura picked up key Lehman Brothers assets in Asia, the Middle East and Europe at discounted prices after Lehman collapsed in 2008.

Due to the calibrated and timed response by the Japanese government, the economy was quick to recover following the financial crisis. Despite the fast recovery, the economy faced new challenges by mid-2010: the nation was experiencing deflation, high public debt, weak domestic demand, softening exports and a strong JPY. In late 2010, the government implemented again stimulus packages focused on job creation, economic growth, social welfare and the revitalizing of regional economies. The stimulus resulted in a promising rebound of the economy. However, the string of bad news was not over.

- Fukushima (2011)

In March 2011 Japan experienced the nuclear disasters of Fukushima. This was caused by a powerful tsunami, triggered by the Tohoku/Great East Japan earthquake. The earthquake was named after its location on the Pacific coast of Tohoku, north-east of Japan. It lasted approximately six minutes with a magnitude of 9.1 and has been the most powerful earthquake ever recorded in Japan and the fourth most intense globally. The earthquake resulted in the deaths of close to 18.000 people.

FIGURE 29: AFTERMATH OF THE TOHOKU EARTHQUAKE AND TSUNAMI



Source: Reuters (2011)

At the Fukushima Daiichi and Daini power plants (owned by Tokyo Electric Power Company) a total of 6 nuclear reactors (supplied by General Electric, Toshiba and Hitachi) were damaged, 4 at Daiichi and 2 at Daini, leading to leakages that resulted in hydrogen explosions.

Contaminated water, various types of cancers and abnormal skin growths from radiations were a few of the consequences of the explosions and affected the population years after the disaster.

The Fukushima nuclear accidents have been largely compared to the Ukrainian Chernobyl disaster of 1986, which was the worst nuclear disaster happened globally both in terms of social costs and casualties.

FIGURE 30: ARIAL PHOTOGRAPH SHOWING HYDROGEN EXPLOSION AT FUKUSHIMA DAIICHI



Source: Getty Images

The Tohoku earthquake, the tsunami, Fukushima accidents and other related aftermaths were undoubtedly a set-back to the Japan's economic recovery. The World Bank estimated the overall cost of the tragedy at 235 billion US\$. Japanese equity markets plunged. The sharpest decline was in the share prices of companies owning nuclear power plants or exposed to nuclear power plants production/maintenance.

However, by the end of 2012 and beginning of 2013, in full "Abenomics", investor confidence had returned. Here the Japanese economy began its recovery. After 22 years the bear market was over.

CHAPTER FIVE: ABENOMICS

- Abenomics, the turn (2012-2020)

Introduction

FIGURE 31: SHINZO ABE, TIME MAGAZINE (2014)



In 2006-2007 (first term post Koizumi) and during the time range 2012 to 2020 (second, third and fourth terms), Japan was led by prime minister Shinzo Abe. Shinzo Abe was the youngest PM when he was first appointed at the age of 52 and went on to be Japan's longest serving PM. This long mandate created a form of political stability for the nation. Prior to 2012 Japan had become accustomed to short-lived PMs: 19 prime ministers followed in the 30 years up to 2012. The office had therefore been nicknamed "the revolving door" due to persistent short-term change.

Abe's administration is well known for its decisive constitutional, farm and agricultural reforms. The economic policies implemented under Abe's administration, now widely referred to as "Abenomics", focused on the implementation of three main reforms (known as the three arrows) namely: aggressive expansionary monetary policy (Abe targeted a 2% inflation rate); fiscal stimulus, structural reforms.

First arrow: Quantitative Easing

Quantitative easing (QE) is a form of expansionary monetary policy characterised by the central bank printing money to finance the purchasing of financial assets (government bonds, shares). This increases money supply in the economy. As a monetary policy instrument QE is widely pursued in the economic context of low or negative interest rates.

Quantitative easing

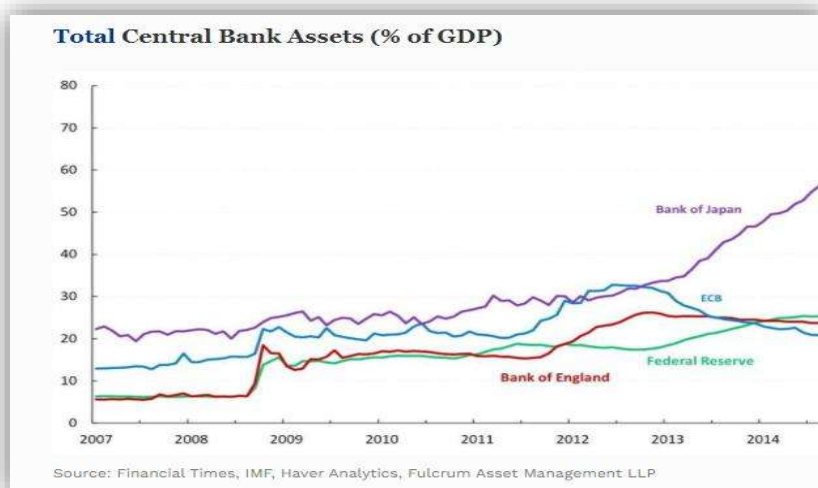
The Central Bank begins purchasing bonds from banks: the price of bonds rises and money flows into the banking system; as consequence, several interest rates lower and loans become cheaper; businesses and people can borrow more and spend less to repay debts; as result investment and consumption grew, supporting economic growth and job creation (ECB's infographic).

Under Abe's administration, QE was implemented since 2012, with the Bank of Japan (BOJ) printing money for purchasing a vast majority of Japanese Government Bonds (JGBs). The BOJ not only focused on financing purchases of safe assets, but also riskier assets. In August of 2012 BOJ purchased Nikkei ETFs up to 92.4 billion JPY, a very large purchase since the ETFs buying initiative commenced in December 2010. Forbes and Barrons report that between 2013 and 2017 BOJ ended up owning about 75% of all Japanese Exchange Traded Funds (ETF) and resulted among the top 10 shareholders of 90% of the Nikkei 225 constituents. Abe's medium-term target with this QE was to reach a 2% inflation rate, moving Japan out its long deflationary status.

Whilst Japan was implementing its own QE programs, other developed nations had already started on similar paths, like the bond buying policy by the European Central Bank (ECB, March 2015) and the US Federal Reserve (November 2008).

The figure below shows how, by 2014, the BOJ had acquired several assets as a percentage of total GDP in comparison to other developed countries. As of 2014, the Japanese government expanded quantitative easing to 80 trillion JPY per year.

FIGURE 32: CENTRAL BANK ASSETS AS % OF GDP (JAPAN, EUROPE, US, UK)



Although it limited a deflationary spiral, the monetary policy failed to increase the targeted inflation rate and by 2018 the Japanese government abandoned any date-setting by which to achieve a 2% rate of inflation. As of March 2021, the government announced its intention to stop buying Nikkei 225 and Nikkei 400 ETFs but to continue buying Topix ETFs. Some of the top ETFs held by the government

included Nomura Asset Management's Nomura Topix ETF, Nikko Asset Management's Nikko Listed Index Fund Topix ETF and Daiwa Asset Management's Daiwa ETF Topix.

The ETFs buying activity resulted in the government being the largest owner of Japanese stocks valued at 47 trillion JPY as of December 2020, surpassing the government's Pension Investment Fund. The government has widely been criticised for this excessive ETF buying activity due to its effect on the stock market, including the distortion of stock prices. Concerns have been raised as well on how or when the ETFs could be off-loaded back onto the market in the future and how big the impact would be on the financial markets. However, as far as the companies bought can produce a significant cash flow compared to the price paid, as it is the case, we deem these concerns baseless.

Second arrow: fiscal policy and consumption tax

Regarding the second arrow, the fiscal policy, Abe's administration allocated approximately 10.3 trillion JPY to support economic growth mainly through financial aid for small-medium enterprises, increasing public works and defence spending.

However, Abe increased consumption tax from 5% in 2013 to 8% in April 2014, actually making the families to support the SMEs.

Third arrow: structural reforms

Considering the third arrow, Abe focused more on liberalisation policies, breaking up regional monopolies in the energy sector as well as encouraging the presence of more women in the workplace (the so-called Womenomics).

Abenomics 2.0

During his second, third and fourth administrations Abe introduced 'Abenomics 2.0' in which he focused on three new reforms which aimed at:

- boosting Japan's GDP to 600 trillion JPY by 2021
- increasing national fertility rate to 1.8 children by mid-2020 and
- tackling the challenge of the aging population (somehow related to the latter)

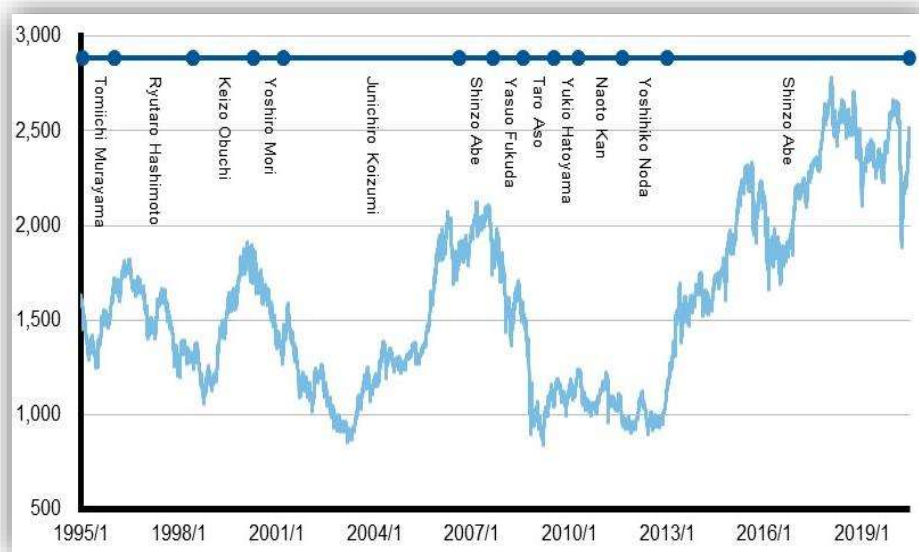
- Financial markets during Abenomics

Beginning of markets normalization: “Japan is back”

In terms of equity market response, there was a very positive upturn in share prices under Abe's mandate, kicking off in 2012. It is reported that at the very beginning of his mandate and looking at market performances Abe declared “Japan is back”. Figure below shows how Japanese equity markets reacted over the years under different political administrations. They did particularly well under Abe, compared to previous prime ministers.

The Japanese economic trend under Abe's administration, and particularly after the Fukushima disaster, improved significantly and public debt stabilised for the first time in years, but all in all the underlying fundamentals of interest rates and inflation didn't change much.

FIGURE 33: MOVEMENTS IN THE TOPIX UNDER DIFFERENT POLITICAL ADMINISTRATIONS



Source: Bloomberg and Russell Investments. Data as at 29 May 2020.

As of 2017 country officials noted that when Abe started his second term the economic growth since December 2012 had surpassed the ‘Izanami Keiki’. The Izanami Keiki was the second post-war long-run period of economic expansion that lasted 73 months, from February 2002 up to February 2008 (Koizumi's policies), when the national economy rebounded following the banking crisis. The “Izanami Keiki” boom succeeded the first long-run expansion period “Izanagi boom” of 1965-70 (“the miracle economy”).

Table 4 below shows some of these economic business cycles between 1951- 2008 and how long they lasted for.

TABLE 3: REFERENCE BUSINESS CYCLES IN THE JAPANESE ECONOMY (1951-2008)

No.	Trough	Peak	Trough	Boom	Recession
1		06/1951	10/1951	Special Procurement boom	
2	10/1951	01/1954	11/1954	Investment boom	
3	11/1954	06/1957	06/1958	Jinmu boom	Flat pan recession
4	06/1958	12/1961	10/1962	Iwato boom	
5	10/1962	10/1964	10/1965	Olympic boom	Security slump
6	10/1965	07/1970	12/1971	Izanagi boom	Nixon Slump
7	12/1971	11/1973	03/1975	Archipelago reform boom	First oil crisis
8	03/1975	01/1977	10/1977		Mini recession (yen revalued)
9	10/1977	02/1980	02/1983		Global recession (second oil crisis)
10	02/1983	06/1985	11/1986	High-Tech boom	Yen revaluation recession
11	11/1986	02/1991	10/1993	Asset price bubble boom	1 st Heisei recession
12	10/1993	05/1997	01/1999	Camphor boom	2 nd Heisei recession
13	01/1999	11/2000	02/2002	IT Bubble	3 rd Heisei deflationary recession
14	02/2002	10/2007	10/2008	Izanami boom	
15	10/2008				Global Financial crisis

Notes: Jinmu is the name of the first emperor in Japanese history. 'Jinmu' boom means the unprecedented boom since Jinmu's reign. Similarly, for Iwato (an event in Japanese myth times), Izanagi (a mythical male figure) and Izanami (a mythical female figure). Heisei is the yearly calendar for the present emperor.

Source: Adapted from Ichimura & Klein (2010).

Conclusions

The implementation of Abe's monetary and fiscal policies at the beginning of his mandate, together with the natural recovery from the previous recession, gave a decisive boost to the economy that was fast reflected in the stock market in 2012, as shown above, and that lasted up to 2018. During this favourable economic recovery and development period though, the Japanese economy has experienced setbacks caused in 2018 by the introduction of a heavier consumption tax and in Q4 2019 by the onset of the Corona Virus pandemic. This compromised the positive average market trend that began in 2012. It can be concluded that Abenomics was successful despite some of its structural reforms remain still to be assessed.

In August of 2020, Shinzo Abe announced his resignation due to ill-health. Abenomics 2.0 still having to be implemented. In September 2020, he was succeeded by Yoshihide Suga from the same conservative political party to which Abe belonged to, the Liberal Democratic Party (LDP).

Abe's legacy has still to be carried on, hopefully fully achieving productivity increase, deregulation and GDP steady growth, moving out of deflation once and for all.

Suga's Administration

In comparison to Abe, who came from a prominent political family, Yoshihide Suga came from a simpler rural background as his father was a strawberry farmer. Abe's right-hand man, Yoshihide Suga has been applauded for his discipline and ability to manage Japan's complex bureaucracy. As chief cabinet secretary, before his election to Prime Minister, Suga would conduct various media briefings and in 2019, he gained the nickname "Uncle Reiwa" after announcing a new imperial "Reiwa" Era ("beautiful harmony") under the new Emperor Naruhito.

FIGURE 34: YOSHIHIDE SUGA (2020- 2021), JPN TIMES



Together with the implementation of the Abenomics policies of his predecessor, Suga's administration intended to focus on foreign policy, digital transformation, supply chains and employment protection, supporting businesses and facilitating the release of Japanese abductees from North Korea.

Furthermore, interfacing with the new Democratic administration in the US, Suga focused on the FOREX market due to the historical US-Japan currency exchange interaction.

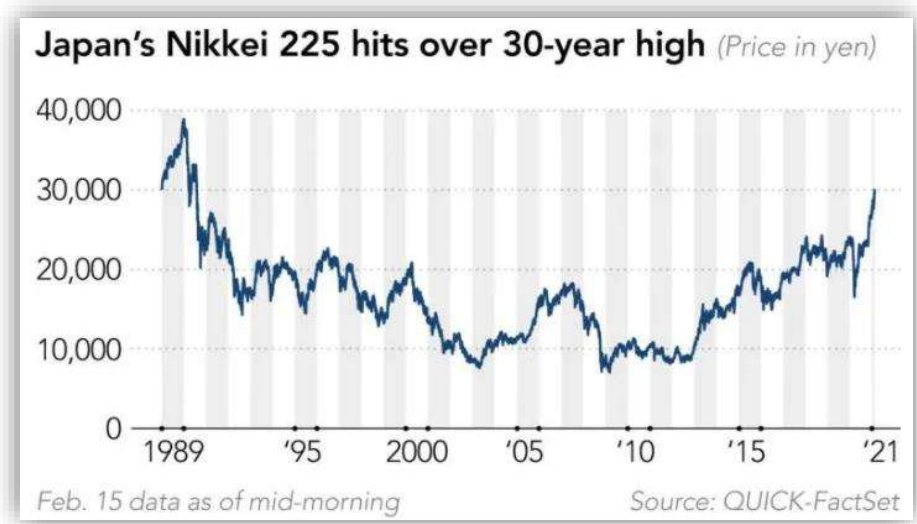
Having inherited a prime ministership impacted by the Covid-19 pandemic, one of Suga's main priorities has been to manage responses to the sanitary emergency through increasing testing and access to vaccination programs. For Japan, the effect of the pandemic goes beyond influencing GDP, it affected the nation's visibility on the global stage through the Olympic games. The games were initially set to be hosted in 2020 but then postponed in order to contain the pandemic.

Despite the initial setback caused by the global pandemic, the economy has bounced back and as of Q1 2021 the Nikkei 225 had reached the 30.000 mark for the first time in 31 years and the TOPIX had risen to a three-decade high, both driven in part by the positive Covid-19 vaccine news, GDP's underlining growth and strong corporate earnings.

Japan's big bet is to carry on with the economic, political, financial and social structural reforms needed to back and support the market deregulation. A lot of work has still to be done but apparently

the country is the right path to exiting from its three decades of economic stagnation and deflation. November's election will reveal more about Japan's attitude towards its reform path.

FIGURE 35: NIKKEI 225 REACHES 30-YEAR HIGH



Change chart

Kishida

Abe death

PART TWO: The Japanese equity market represents an anomaly

CHAPTER SIX: A DIFFICULT PAST FOR EQUITIES

- Japanese Equity: a difficult past ...



1) From 1983 to 1990 the Nikkei 225 multiplies by 6

From 1983 Japan started implementing protectionists trade policies, investing in technological efficiency (mainly in manufacturing industry and consumer electronics) and human capital together with an efficient use of resources. Through this, Japan's economy underwent an explosive growth in GDP, aligning to the main world's economies and even surpassing the UK to become the second largest economic power after the US.

In 1985 the USA implemented an agreement called the Plaza Accord which depreciated the U.S. dollar relative to the Japanese Yen. In the two years following the signing of the Plaza Accord the US\$ depreciated and the trade deficit reversed, meaning the Japanese trade surplus, formerly driven mainly to export towards US, began to decline. This led the Japanese central bank and government to compensate for the loss of economic growth with expansionary monetary and fiscal policies for an already euphoric securities and real estate market. Between 1985 and 1987 the Bank of Japan intervened five times by cutting interest rates and pushing the cost of credit down from 5% to 2.5%. The economy boomed and the banking sector started to offer cheap credit without project risk assessment.

2) 1989 – Index record 38.916

The Japanese stock market reached its peak at 38.916 in 1989 on the Nikkei index, the same year the bubble burst. When the bubble burst in 1989, the JPY was trading at 125 to US\$, when 20 years earlier it had been worth 360. The main cause of the bubble bursting was thought to be the Bank of Japan's intervention in increasing interest rates to control inflation. Inflation had grown due to the expansive monetary policy implemented to offset the JPY appreciation following the Plaza accord and was fed by the financial bubble.

3) 1990-2009 the breakdown

The post bubble period from 1990 is considered the lost decade of Japan, and continuing till 2011, it is considered the lost 20 years. These years are characterised as a long period of decline with medium-term fluctuations. Stock market returns -measured by the TOPIX- reached a peak in 1989 and began to decline after the asset prices bubble burst. In the post-bubble period, equity financing and convertible bonds decreased drastically. From 1991 on, financing from straight corporate bonds increased gradually. As interest rates increased at the start of the 1990s due to a tightening monetary policy, stock prices began to plunge. There was increased selling pressure, which forced most of the market participants, highly leveraged in stocks, into financial turmoil. Even when interest rates, both short and long term, returned to low levels following a supportive monetary policy post crisis, asset prices remained low for a while.

4) 2009: After the global financial crisis the index – 82% from the highs of 20 years earlier

From the third quarter of 2008, following the global financial crisis, the Japanese economy entered another recession. Despite the US being the epicentre of the crisis, Japan was hit twice as hard

compared to the US economy. These great differences have been attributed to the fact that by the time the global financial crisis hit, the Japanese economy had not fully recovered from its own woes. The TOPIX stock index fell to a new post-bubble low, down 61% from its February 2007 high, and 76% from its all-time high.

Japan was able to somewhat recover due its calibrate and timed response by the Japanese Government by providing stimulus packages to both firms and households, and the Bank of Japan injected funds into the banking system to support interbank borrowing as well as to encourage lending and asset purchases. Despite this, the economy was hit by deflation in the third quarter of 2009. Then by mid-2010 the nation was experiencing deflation, high public debt, weak domestic demand, softening exports and a strong JPY.

5) 2011, the earthquake

In March 2011, Japan was hit by the great Tohoku/Great East earthquake which also triggered a devastating tsunami. The earthquake lasted approximately six minutes with a magnitude of 9.1 and was the most powerful earthquake ever recorded in Japan, resulting in the death of approximately 18,000 people. The devastation continued with the Fukushima Daiichi and Daini power plant's being damaged, leading to leakages that resulted in hydrogen explosions. This was the worst nuclear disaster to have happened globally both in terms of social costs and casualties, with long lasting impacts from the nuclear fallout and water and soil contamination. These horrifying events were undoubtedly a set-back to the Japan's economic recovery. Following the shock, Japan's real GDP had decreased in 2012 by approximately 0.47% (figure 20 and 21, page 47) and the World Bank estimated its overall cost at 235 billion US\$. Japanese equity markets plunged. The sharpest decline was in the share prices of companies owning nuclear power plants or exposed to nuclear power plants production compared to others in the energy sectors, particularly electricity.

6) 2012: Recovery begins but deflation continues – Abenomics does not materialise

By the end of 2012 and beginning of 2013, "Abenomics" "was in full bloom, and investor confidence had returned. This is a set of economic policies set out for Japan in 2012 when prime minister Shinzo Abe came into power for a second time, which involved increasing the nation's money supply, boosting government spending, and enacting reforms to make the Japanese economy more competitive. There was at last a positive turn in the equity market as the Japanese economy began to recover again. Quantitative easing policy was also introduced by the central bank by printing money

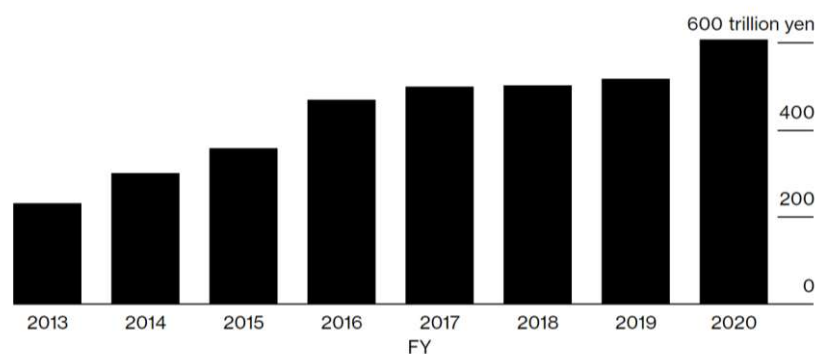
to finance the purchasing of financial assets (government bonds, shares) to increase money supply in the economy. However, the policy failed to increase the targeted inflation rate and by 2018 the Japanese government abandoned any date-setting by which to achieve a 2% rate of inflation. This meant that deflation continued despite the positive upturn in share prices under Abe's mandate, kicking off in 2012.

CHAPTER SEVEN: JAPANESE EQUITIES ARE AN ANOMALY

- After three decades of stagnation, an anomaly unique in the world

As a result of Japan's troubled history and very long period of decline, Japanese companies have built into their DNA a highly conservative attitude in terms of managing the cash they generate. This explains why, despite the improved outlook following the financial crisis, the corporate world has continued to increase its cash levels, although, as we shall see later, this attitude is now changing.

FIGURE 41: JAPAN: CASH* HELD BY LISTED COMPANIES

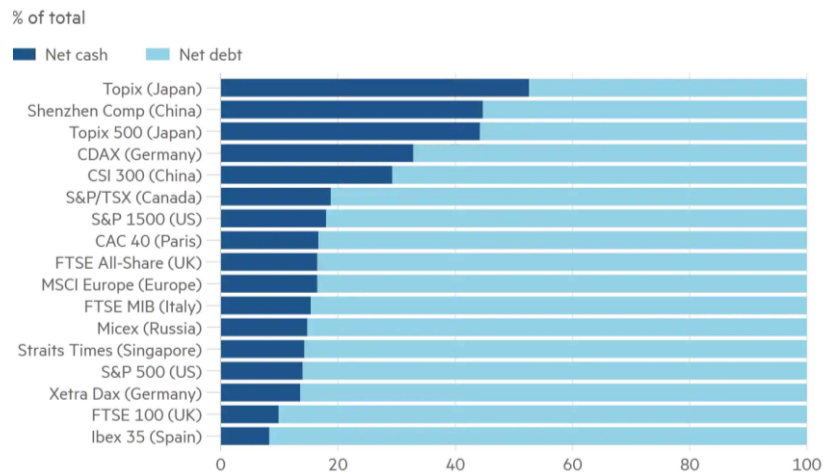


Source: Bloomberg

- Market capitalisation of approximately US\$7 trillion Vs cash on hand of approximately US\$4 trillion
- Around 60% of listed companies are debt-free (compared to less than 15% in the US or less than 20% in Europe).
- Nearly 45% of listed companies trade at less than 1 times Tangible Net Assets

- About 1/3 of the listed companies have cash for more than 40% of their market capitalisation.

FIGURE 42: JAPAN, CASH SUPERIOR TO ALL OTHER AREAS OF THE WORLD



Fonte: Factset, CLSA

- Enthusiasm: very little...

FIGURE 43: JAPANESE STOCK MARKET ALLOCATION



Source: BofA Global Fund Manager Survey – 19/10/21

Orphan Companies represent a neglected segment of a market that is itself neglected, as can be seen from the chart above, which highlights the general underweight of investors. However, there are several changes in place that could lead to a strong repositioning in this equity market, which will be presented later.

CHAPERT EIGHT: CORPORATE GOVERNANCE AND STEWARDSHIP CODES

- The Japanese Corporate Governance (CGC) and Stewardship Codes

The Corporate Governance Code

The Corporate Governance Code (CGC) offers fundamental principles for effective corporate governance of listed companies in Japan. The Code was first compiled in 2015 and was incorporated into the Tokyo Stock Exchanges rules on a 'comply or explain' basis. The latest revision came into effect from June 2021.

The most recent version of the Japanese Corporate governance code is structured by 5 general principles. Under each general principle are principles with further supplementary principles:

1) Securing the rights and equal treatment of shareholders

Companies should take appropriate measures to fully secure shareholder rights and develop an environment in which shareholders can exercise their rights appropriately and effectively. Shareholder should also receive equal treatment from the company.

- Securing the Rights of Shareholders
- Exercise of Shareholder Rights at General Shareholder Meetings
- Basic Strategy for Capital Policy
- Disclosure of cross-shareholdings
- Explanations and Procedures of Anti-Takeover Measures
- Procedures and Explanations of Capital Policy that May Harm Shareholder Interests
- Procedures for Related Party Transactions to not harm the interests of the company

2) Appropriate Cooperation with stakeholders other than shareholders

Companies should fully recognize that their sustainable growth and the creation of mid-to long-term corporate value are brought about as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities. As such, companies should endeavour to appropriately cooperate with these stakeholders.

- Business Principles as the Foundation of Corporate Value Creation Over the Mid- to Long-Term
- Implementation of Code of Conduct
- Addressing of Sustainability Issues, Including Social and Environmental Matters
- Ensuring Diversity, Including Active Participation of Women
- Establishment of Framework for Whistleblowing
- Roles of Corporate Pension Funds as Asset Owners

3) Ensuring Appropriate information disclosure and transparency

Companies should appropriately make information disclosure in compliance with the relevant laws and regulations but should also strive to actively provide information beyond that required by law. This includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and business issues, risk and governance

- Full disclosure of information in compliance with the law and beyond what is required by law.
- External Auditors

4) Responsibilities of the Board

in order to promote sustainable corporate growth and the increase of corporate value over the mid to long-term and enhance earnings power and capital efficiency, the board should appropriately fulfil its roles and responsibilities.

- Establishment of Corporate goals (business principles etc.)
- Establishment of an environment that supports appropriate risk-taking by the senior management as a major aspect of its roles and responsibilities
- Effective oversight and evaluation of the management and directors from an independent and objective standpoint as a major aspect of its roles and responsibilities.
- Roles and Responsibilities of Kansayaku* and the Kansayaku* Board.
- Directors, kansayaku* and the management of companies should secure the appropriate cooperation with stakeholders and act in the interest of the company and the common interests of its shareholders.
- Business Execution and Oversight of the Management
- Roles and Responsibilities of Independent Directors
- Effective Use of Independent Directors

- Independence Standards and Qualification for Independent Directors
- Use of Optional Approach
- Preconditions for Board and Kansayaku* Board Effectiveness
- Active Board Deliberations
- Information Gathering and Support Structure
- Director and Kansayaku* Training

5) Dialogue with the shareholders

In order to contribute to sustainable growth and the increase of corporate value over the mid- to long-term, companies should engage in constructive dialogue with shareholders even outside the general shareholder meeting

- Policy for Constructive Dialogue with Shareholders
- Establishing and Disclosing Business Strategies and Business Plans

Revisions in the code - June 2021

Here below the main points of the proposed revisions to the Code and the Guidelines, that represent a significant progress, reducing the corporate governance gap between Japan and the other major OECD countries:

- Sustainability
- board independence
- diversity

Sustainability. The aim of the revision was to draw the attention of Japanese Companies towards environmental, social, and governance (ESG) related matters. Frameworks to promote sustainability management and dialogue with investors regarding this topic is put forward in this revision.

In the revision, as part of General principle 2 (Appropriate cooperation with stakeholders other than shareholders) it is stated: *“Moreover, given that the Sustainable Development Goals (SDGs) were adopted at the United Nations Summit and the number of organizations supporting the recommendation of the FSB’s Task Force on Climate-related Financial Disclosure (TCFD) has increased, there is a growing awareness that sustainability (mid-to long-term sustainability including ESG factors) is an important management issue from the perspective of increasing mid to long-term corporate value.*

In light of this, it is important for Japanese companies to further promote positive and proactive responses to sustainability issues.”

Japan is a leading supporter for Task Force on Climate related financial disclosure (TCFD), as can be seen from the chart below, and the percentage of Japanese companies with SDGs target policy are growing (above 10% of Topix).

Attention to sustainability and ESG

- Development of a basic policy and disclosure on the company’s sustainability
- Enhancement of the quality and quantity of climate-related disclosure based on TCFD recommendations of equivalent international frameworks at Prime Market listed companies.

These revisions support this finding and show Japan’s likeliness to commit to issues regarding sustainability.

Task Force on Climate-related Financial Disclosure (TCFD) - Top 5 Countries by Number of supporters

Japan	527
United Kingdom	384
United States	345
Australia	125
France	117

Source: TCFD – October 2021

#Enhancing board independence and governance structure

- Increasing independent directors from at least two to at least one-third of the board for Prime Market Listed companies.
- Establishment of a nomination committee and remuneration committee. (For Prime Market listed companies, a majority of the committee should be independent)

- Disclosure of a skill matrix of board members conforming to the company's business strategy.
- Appointment of independent directors with managerial experience at other companies.
- Appointment of enough independent directors to have them form a majority of the board or establish an independent special committee at Prime Market listed subsidiaries so as to cope with conflicts of interest between their parent company and minority shareholders.
- Promotion of the use of electronic voting platforms and disclosure in English at Prime Market listed companies.

Promoting diversity

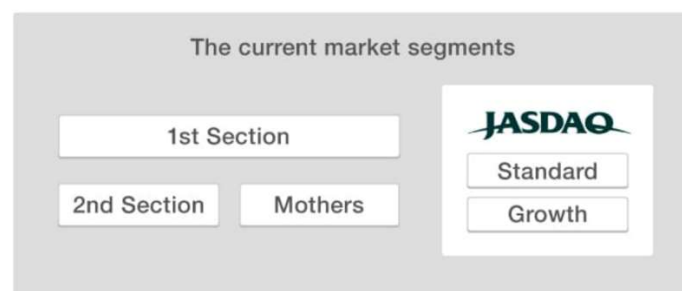
- Disclosure of a policy and voluntary measurable targets in respect of promoting diversity in senior management by appointing females, non-Japanese and mid-career professionals.
- Disclosure of human resource development policies ensuring diversity, including the status of implementation.

Tokyo Stock Exchange Restructuring

The planned restructuring of the Tokyo Stock Exchange (TSE) for April 4th, 2022 should be commented upon before mentioning the main revisions in the Corporate Governance Code (CGC). This is because the new revisions of the CGC incorporate standards regarding this reorganization.

The Tokyo Stock Exchange market will be re-structured into three new market segments of 'Prime Market' (i.e. blue-chips), 'Standard Market' (mid-small cap), and 'Growth Market' (startups). For each market, there are requirements for certain thresholds on liquidity, governance, business performance, financial status, and business plans.

Tokyo Stock Exchange Restructuring (April '22)



The new market segments

Prime Market	Standard Market	Growth Market
- For companies which centre their business on constructive global dialogue with investors. - At least ¥10bn (US\$94.7mn) in "tradable share market cap" and at least 35% of "tradable share ratio"	- For companies with sufficient liquidity and governance levels to be investment instruments. - At least ¥1bn (US\$8.675mn) in "tradable share market cap" and at least 25% of "tradable share ratio"	- For companies with high growth potential - At least ¥0.5bn (US\$4.337mn) in "tradable share market cap" and at least 25% of "tradable share ratio" - Reasonable business plans and matters related to high growth potential should be published

Source: Tokyo Stock Exchange

The creation of the new criteria could prompt small-cap and illiquid names to revamp themselves in order to meet the new standard set by TSE and to be listed on the *Prime Market*, both in terms of governance and liquidity threshold (Prime segment: at least ¥10bn in "tradable share market cap" and at least 35% of "tradable share ratio").

Listing Criteria for the Prime Market

Listing Requirements				
Item	Purpose	Outline of Listing Requirements		
Liquidity	➢ Basic criteria to ensure effective basis of ample liquidity for various types of institutional investors to find the stocks investable	Criteria	Initial Listing	Continued Listing
		No. of Shareholders	At least 800 shareholders	At least 800 shareholders
		No. of Tradable Shares	At least 20,000 units	At least 20,000 units
		Tradable Share Market Cap	At least JPY 10 bn.	At least JPY 10 bn.
		Trading Value	At least JPY 25 bn. mkt. cap	At least daily JPY avg. 20 mn.
Governance	➢ Basic criteria to ensure effective foundation for constructive dialogue between listed companies and institutional investors ※ Revised CG Code fully applied(*)	➢ To ensure constructive dialogue with institutional investors, must maintain "public market control" by keeping tradable share ratio, with so-called "stable shareholders" holding less than 2/3 of shares (threshold to pass a special resolution under the Companies Act)		
		Criteria	Initial Listing	Continued Listing
		Tradable Share Ratio	At least 35%	At least 35%
Business Performance Financial Status	➢ Stable and Excellent Revenue/Financial Base	Criteria	Initial Listing	Continued Listing
		Business Performance	Total profit for recent 2 yrs., at least JPY 2.5 bn. Sales at least JPY 10 bn. & market cap at least JPY 100 bn.	—
		Financial Status (Shareholder Equity)	at least JPY 5 bn.	positive

(*) including principles requiring a higher level of governance applied to Prime-listed companies

Source: Tokyo Stock Exchange

The Japanese Stewardship Code

The Japanese Stewardship Code is a set of regulatory guidelines for institutional investors to fulfil their responsibilities to promote sustainable growth of companies through investment and dialogue. The code mainly targets institutional investors who are invested in Japanese listed shares.

It was created by the Japanese government's Financial Services Agency to encourage Japan's institutional investors to become more involved with the companies they are invested for the country to eventually have better-run, faster-growing companies. On the founding document, 'stewardship responsibilities' refers to the 'responsibilities and of institutional investors to enhance the medium to long-term investment return for their clients.

The code was originally proposed in 2012 as a response to the 2008 financial crisis. It was then officially published in 2014 alongside an English version. The Corporate Governance Code was then drafted the following year as the two were made to support each other. With the two-working hand in hand, investors and investees are both able to contribute to the growth of the economy.

Outline of the Stewardship Code

There are Eight main principles of the code, and each principle comes with several notes of guidance. Below are the main eight principles of the code. To see the guidelines please find the full version of the code at the end.

- 1) Institutional investors should have a clear policy on how they fulfil their stewardship responsibilities, and publicly disclose it.
- 2) Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.
- 3) Institutional investors should monitor investee companies so that they can appropriately fulfil their stewardship responsibilities with an orientation towards the sustainable growth of the companies.
- 4) Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.
- 5) Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.
- 6) Institutional investors in principle should report periodically on how they fulfil their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries

- 7) To contribute positively to the sustainable growth of investee companies, institutional investors should develop skills and resources needed to appropriately engage with the companies and to make proper judgments in fulfilling their stewardship activities based on in-depth knowledge of the investee companies and their business environment and consideration of sustainability consistent with their investment management strategies.
- 8) Service providers for institutional investors should endeavour to contribute to the enhancement of the functions of the entire investment chain by appropriately providing services for institutional investors to fulfil their stewardship responsibilities.

Revisions to the Stewardship Code

The newest revision of the Stewardship code was finalised and published by Japan's Financial Services Agency on the 24th of March 2020. This revision came after the second revision of the Corporate Governance Code to assist in Japan's economic revival programme by progressing the Japanese government's corporate governance reform.

The focus of the revision of the Stewardship code surrounded sustainability and also the disclosure of the reasons for voting. The plan is to encourage previously passive investors' involvements into more active engagements. Other key changes can be seen below:

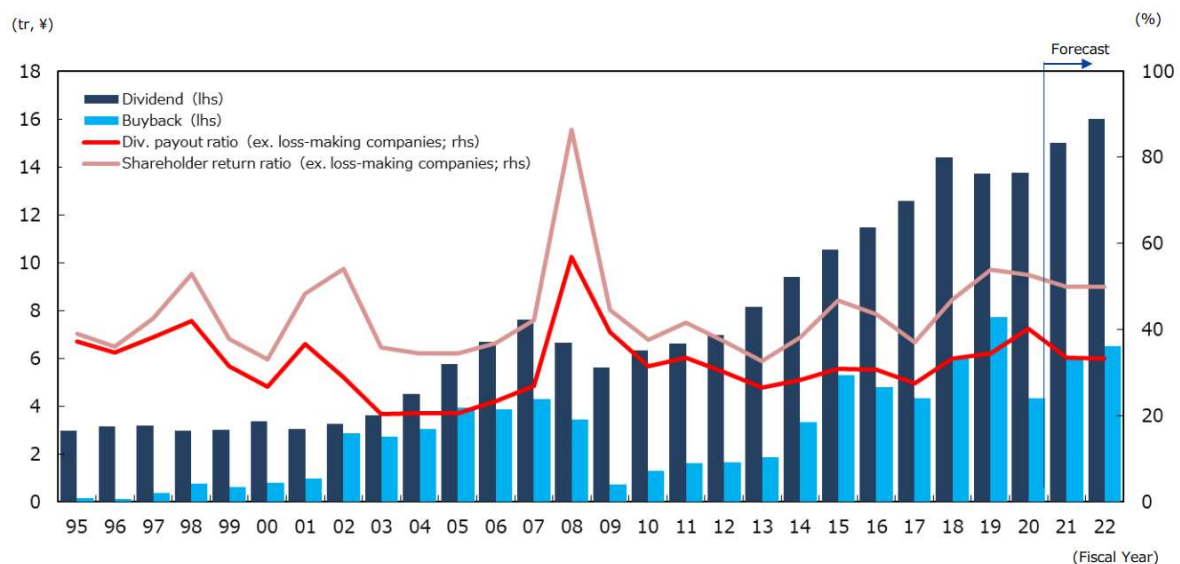
- Focus and consideration on sustainability (Including ESG factors)
- Clear disclosure of reasons for votes on agenda items
- Further encouragement of stewardship activities of asset owners such as corporate pension funds
- Application of the Code to asset classes other than listed shares
- Applying principles to service providers for institutional investors.

CHAPTER NINE: SHAREHOLDER RETURN AND M&A

• Increased total shareholder return

After the Covid interlude, dividends in 2021 are expected to exceed 2019's record levels, as seen in the chart presented below. According to a recent Nikkei Asia survey of 1,800 listed companies, 36% of the sample plan to increase their payout, up 4% from last year, reflecting both greater confidence in the outlook and a change in attitude towards foreign shareholders' demands for higher returns.

Figure 49: Shareholder Return Ratio, Div. Payout Ratio, Dividend Payment, & Share Buyback



Source: SMDAM

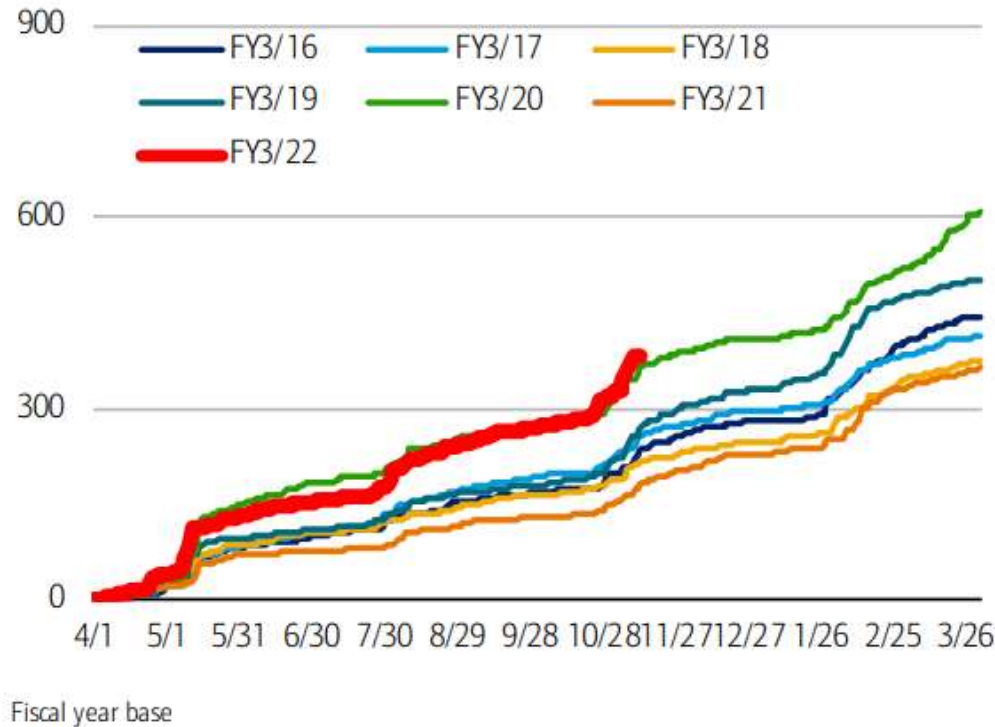
Historically, the payout ratio of Japanese listed companies has been lower than that of other developed markets, particularly compared to US and European companies (payout ratio in recent years around 40% compared to 50% in Europe and the US).

In many cases, Japanese corporations have preferred to adopt a stable dividend policy in absolute terms, partly to meet the resistance that retail investors would have to a more flexible dividend policy. Retail investors, who own about 20% of the local stock market, are largely made up of retirees who prefer a steady stream of dividends, rather than a dividend that rises or falls on an annual basis depending on company earnings.

Dividend growth is associated with an increase in buyback plans, which are becoming increasingly popular among Japanese companies as a means of returning the huge amount of cash they have

accumulated, obviously with the upward effect on EPS that this entails. From the graph presented below, it can be seen that the number of share buyback plans announced in the current fiscal year exceeded 2019 levels (i.e. the first seven months of fiscal year 2022, which ends in March 2023).

Figure 50: Number of buyback announcements by companies listed on the Topix index by fiscal year



Source: Astra Manager

Although buybacks are more popular, few companies are currently opting for them compared to other developed markets. This explains why, when looking at the total shareholder return ratio (return of capital formed by dividends and buybacks), Japan is less generous than other markets, such as the US, where buyback plans have for many years exceeded the amount of profits distributed to shareholders in the form of cash dividends, or European markets.

It must be said that buybacks in Japan could now increase as a way of distributing the proceeds from the sale of strategic holdings, particularly in the banking sector, which is in the process of selling off a significant number of stakes in listed companies.

• M&A in Japan on the rise

Over the past few years, the number of M&A transactions within the Japanese market has increased significantly.

The number of transactions has risen both for the domestic market, i.e. transactions between Japanese companies ("IN-IN"), and for acquisitions of foreign companies by Japanese companies ("IN-OUT"). Also noteworthy is the increased fervour on the part of foreign companies to make acquisitions in the Japanese market ("OUT-IN"), emblematic of which is the attempted acquisition of Toshiba by private equity operators, which was recently followed by the announcement of a break-up by the same company (see box below).

Specifically, with regard to 'IN-IN' transactions, the number of M&A transactions rose from 2174 in 2006 to 2987 in 2019, demonstrating the desire to accelerate the restructuring process and deal with structurally negative elements of the Japanese economy, especially the demographic decline and the rigidity of the labour market (rigidity that mainly affects the entry of foreign workers). In 2017/18 in Japan, the METI (Minister of Economy, Trade and Industry) introduced a tax reform aimed at protecting shareholders of conglomerate companies from tax burdens in the event of corporate demergers. The aim of this measure was to stimulate corporate simplification, with the creation of simpler corporate entities, suitable for undertaking

Is a wave of mergers in the banking sector on its way?

The Japanese banking system is characterised by a large number of regional banks, which, unlike the Japanese mega-banks created by the restructuring of the financial system in the early 2000s, are very local and play an essential role in the survival and development of small businesses. They also assist local communities in times of difficulty, more directly and effectively than national banks.

Two years ago, the FSA released a study showing that in about 50% of prefectures, even a single bank controlling the whole market could not be profitable with its core business alone. This risks endangering a sector that is fundamental to the area, and so the priority of the government and the BoJ (Bank of Japan) is to strengthen it.

Yoshihide Suga had promoted legislative initiatives to encourage consolidation, including a law eliminating all regulatory scrutiny for regional banks merging in the same prefecture. Moreover, in the event of a merger between regional banks, the BoJ will increase the return on reserves left with it by the new group by 0.1%. Finally, in the case of a merger involving regional banks exposed to rural prefectures with declining populations, the government will grant aid of about \$25m to cover the costs of workforce reduction.

After so many years of waiting, a wave of M&As is inevitably coming, because: the political will is absolutely determined and shared; it is now clear that digitisation is inevitable, but also expensive; company valuations are so low that there is only money to be gained from a merger for all parties involved. Few companies can be more cautious and experienced in lending policy than Japan's regional banks, which have had to manage 30 years of bursting multiple financial bubbles, natural disasters, the country's economic recessions, deflation, and structural industry crisis. Against this backdrop, it is understandable why online financial boutique SBI Holding has launched a bid for Shinsei Bank with the aim of restructuring it and offering a service platform for Japanese regional banks.

aggregation operations, improving the probability of survival and development. This process of transforming conglomerates into pure companies was supposed to lead to a wave of M&A operations, which in reality does not seem to have really started.

However, together with tax reform there are a number of other factors that are now pushing in this direction:

- 1) the new corporate code of conduct (which focuses on independent board members);
- 2) the moral suasion of the government and the BOJ to reduce cross-shareholding between companies (even today about 1/3 of the shares in Japanese listed companies are held by cross-shareholders who tend to maintain the status quo);
- 3) the increase of activist Western shareholders;
- 4) less government and court involvement in corporate actions. The number of transactions could therefore rise further, and significantly.

As for "IN-OUT" acquisitions of foreign companies, these have risen from 421 in 2006 to 824 in 2019, as a consequence of both the critical elements mentioned above relating to the domestic market, to which are obviously added aspirations to acquire technology or access to emerging markets with strong growth potential or access to jurisdictions where Japanese companies are barred from entering.

After a stagnant 2020 due to the Covid-19 pandemic, transactions in the first eight months of 2021 are up 15.8% compared to the same period in 2020, the highest number since 1985, when this data collection began (source: Recof Corp). It should be noted that 1985 was also the last year of the Japanese speculative bubble. With regard to "IN-IN" 2021 transactions, a series of deals should be highlighted, especially in the Information Technology sector and in the restaurant and hospitality services sector. Of particular note was the attempted takeover of Shinsei Bank, a smaller government-controlled bank, by SBI

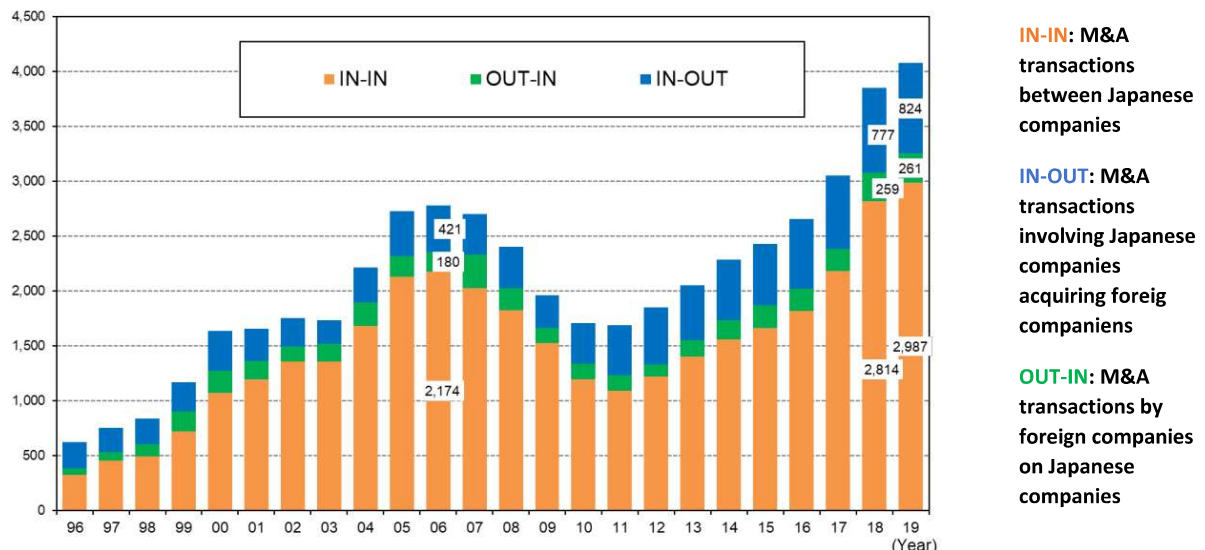
Toshiba: break-up after Cvc Capital's failed bid

At the beginning of April 2021, British investment fund CVC Capital Partners launched an offer worth around EUR 15.3bn for Toshiba, at a premium of around 30% to stock market prices. The offer came as a surprise, after a difficult phase for the conglomerate, which had suffered from accounting scandals and significant losses in the nuclear sector for its US subsidiary, which had forced it to sell the majority share of memories to a consortium led by Bain Capital to avoid financial collapse. The acquisition led to the surprise exit of CEO Nobuaki Kurumatani, who was leading the turnaround process, and a legal battle between activist funds and the company, which sought government support to block the advance of foreign investors. About 7 months later, Toshiba announced that it is ready to split into three parts: 1) a division with office machines and with the aim of listing Kioxia, the subsidiary active in memories; 2) the Device division (which will contain mostly hard disks and semiconductors); and 3) the Infrastructure division, active in many sectors that now have great growth prospects (including nuclear power, which makes it strategically important for the country and not acquirable by foreign subjects).

Holding, a Japanese online financial boutique (see box on page 89).

In terms of "IN-OUT" transactions, Hitachi's acquisition of the US company Global Logic for around USD 10 billion in 2021 is worth mentioning, as is Panasonic's acquisition of Blue Yonder, also in the US, based on a value of USD 8.5 billion.

Figure 51: Number of mergers and acquisitions (M&A) transactions 1996-2019



* excluding intercompany transactions

Source: RECOF, SMBC NIKKO Securities

Further support for the transformation of the Japanese corporate world, with regard to smaller companies, has come from the Government, which in March 2021 launched a series of measures aimed at encouraging M&A activity. A number of innovations have been introduced, in particular the possibility of making provisions for part of the acquisition cost tax deductible in order to deal with unexpected critical situations that may arise once the acquisition has been made. In addition, a 10% tax deduction is provided for investments aimed at obtaining greater synergies from the acquisition. Finally, the possibility of having a tax deduction on higher labour costs following a merger, a measure obviously aimed at preserving jobs post-merger, is also important. All the above measures are conditional on the preparation of a restructuring plan focusing on increased productivity and job preservation.

FIGURE 52: FISCAL IMPACT OF SMALL AND MEDIUM-SIZED OPERATIONS

SME's action	Details of tax relief
(1) Can set aside as reserves a portion of the cost of the acquisition to accommodate unexpected situations that are discovered post-acquisition	Charges to the reserves can be counted as a loss (expense)
(2) Make business investments to increase synergy	A tax deduction of 10% of the investment amount is allowed
(3) Maintain jobs following the acquisition and increase the size of the overall payroll	A tax deduction for a portion of the payroll increase is allowed

Fonte: BofA

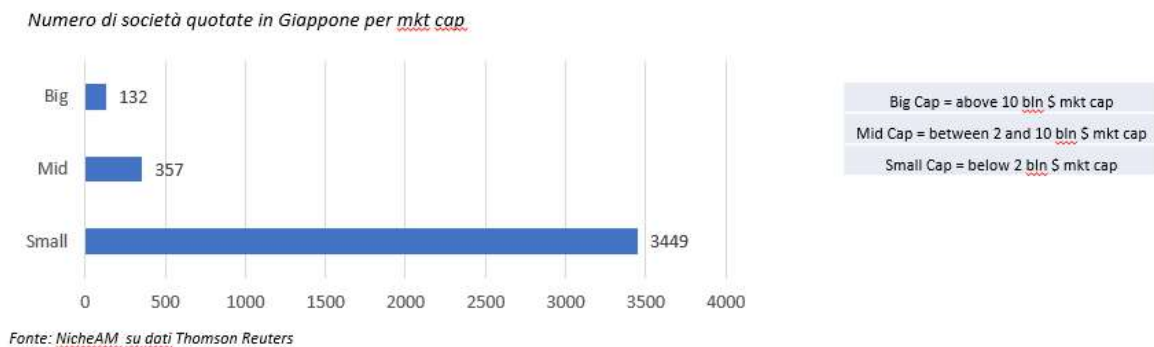
This increasing M&A activity, driven of course by changes in corporate governance and increased investor activism, is a catalyst for the stocks in the Orphan Companies portfolio, whose value/deep value connotation is an appealing element for potential acquiring groups, along with potential delisting by the controlling shareholder, as evidenced by the recent management buyout

CHAPTER TEN: ORPHAN COMPANIES

- In a market that is an anomaly, there are clearly extreme anomalies: the Orphan Companies

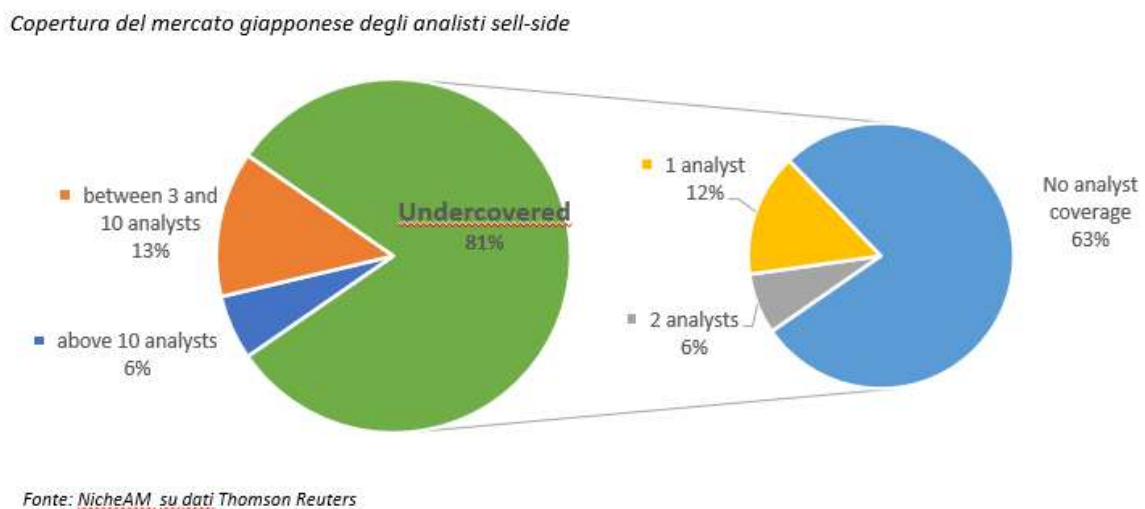
Over 80% of the 3800 or so listed companies are **small caps**.

Figure 53: Number of Japanese listed companies by capitalisation



About **80%** of listed companies are **not covered by analysts**

Figure 54: Japanese market coverage by sell-side analysts



Tot companies not covered **2402**

Tot companies under-covered **3078**

- The fund will invest in equities with the following characteristics

- Substantial **lack of cover** from brokers
- **Net cash**
- **Ratio of capitalisation to tangible net worth less than 1.2x**
- **Listed for at least ten years**
- **Free float of at least 2 billion yen (liquid)**

This is a universe of about **1100 securities**, with an average capitalisation of about \$290m.

If we had decided to use more stringent criteria in terms of selection, the number of companies would still have been very large:

- a) If we had taken companies with P/BVT less than 0.8 times, the number of securities would have been close to 620
- b) If we had taken companies with net cash* equal to 50% of their capitalisation, we would still have had 640 securities.

- **ESG – SDG - Engagement**

The fund falls under **Article 8 of the SFDR regulations ("light green investments")**, i.e. it promotes, among others, environmental or social characteristics, provided that the companies in which it invests respect good governance practices.

The analysis of corporate governance factors is qualitative and takes into account elements such as the diversity of the Board of Directors, its independence, experience, turnover, ability to direct corporate strategy, employee relations and compliance with legal and tax requirements.

As the fund focuses on Orphan companies that are mainly small cap companies, it is possible that some of these companies may not be able to publish a sustainability report or make available a report that accounts for sustainability in their operations and growth processes in relation to the Environmental and Social component. In the event of this occurring, an engagement activity will be carried out, with the aim of improving both the sustainability culture and processes within the investee company and its reporting processes.

Believing that **engagement** is the most powerful tool to spread sustainability processes among small companies, we will try to generate added value by offering companies insights and knowledge sharing

in relation to ESG investments. In fact, NicheAM considers this direct engagement an essential part of the investment process: engaging with companies on ESG issues enables them to improve their fundamentals in the medium to long term.

All engagement activities with investee companies, through e-mails, calls, video calls, meetings, will be archived through an integrated analysis report. Engagement objectives for each investee company will be set and periodically reviewed, together with the progress made in achieving them.

A proprietary ESG scoring system will be used for the analysis, which may also leverage ESG data from third parties, including Thomson Reuters, to identify all relevant ESG factors within the investee's industry.

Examples of environmental and social factors covered by direct engagement with investee companies include: workplace conditions, access to healthcare, workforce diversity and inclusion, improved sustainability reporting, land use, water and waste management, use of renewable energy and supply chain focus on working conditions and sustainability issues.

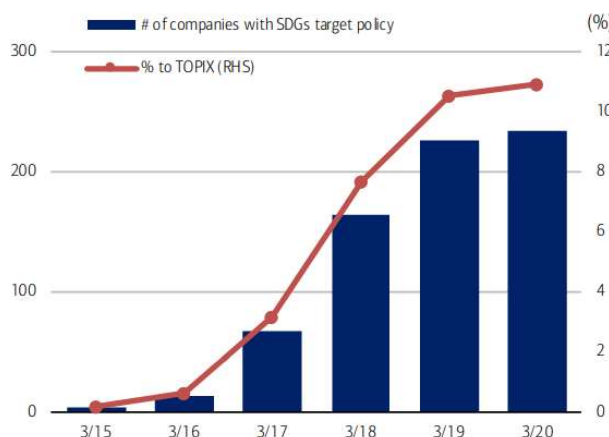
The Fund seeks to invest primarily in securities issued by companies that make a positive impact instrumental in achieving the 17 **Sustainable Development Goals** ("SDGs") as defined by the United Nations ("UN"):

- (1) ending poverty in all its forms throughout the world
- (2) ending hunger, achieving food security and improved nutrition, and promoting sustainable agriculture
- (3) Ensure healthy lives and promote well-being for all at all ages.
- (4) to ensure inclusive and equal quality education and to promote lifelong learning opportunities for all
- (5) Achieve gender equality and empower all women and girls.
- (6) Ensure availability and sustainable management of water and sanitation for all
- (7) Ensure access to affordable, reliable, sustainable and modern energy for all,
- (8) Promote durable, inclusive and sustainable economic growth, full and productive employment and decent work for all
- (9) Build resilient infrastructure, promote inclusive and sustainable industrialisation and foster innovation
- (10) Reduce inequalities within and between countries
- (11) make cities and human settlements inclusive, safe, flexible and sustainable
- (12) ensure sustainable consumption and production patterns

- (13) taking urgent action to combat climate change and its consequence
- (14) to conserve and make sustainable use of the oceans, seas and marine resources for sustainable development
- (15) protecting, restoring and promoting the sustainable use of terrestrial ecosystems, sustainably managing forests, combating desertification, and halting and reversing land degradation and halting biodiversity loss
- (16) promoting peaceful and inclusive societies for sustainable development, providing access to justice for all and building effective, accountable and inclusive institutions at all levels
- (17) Strengthen implementation arrangements and revitalise the global partnership for sustainable development.

Japanese companies have increased their sensitivity to the SDG targets significantly in recent years. As shown in the chart below, almost 10% of the companies in the Topix index had an SDG target policy in March 2020, and the increasing trend of adopting this policy continued over the following year.

Figure 55: Number of companies in the Topix index with an SDG target policy



Source: BofA, Bloomberg

In line with its Responsible Investment Policy (click here to view it), Niche AM also applies an exclusionary policy to investments in companies exposed to armaments, tobacco and fossil fuels. Investments will therefore be excluded in:

- companies involved in the production, sale or stockpiling of uranium weapons;
- companies involved in the production or sale of anti-personnel mines and cluster bombs prohibited by the Oslo and Ottawa treaties;
- companies generating revenues in excess of 10% of total revenues from arms;
- Companies that generate revenues in excess of 10% of total revenues from tobacco;
- Companies with revenues exceeding 10% of total revenues from thermal coal; and
- companies that generate revenues in excess of 10% of total revenues from upstream oil.

• Risks Vs Opportunities

Below we present what we believe to be the main risks and opportunities related to the Japanese Orphan Companies investment case.

RISKS:

1. *A forgotten market that continues to be forgotten*

Here there is little to add. A market like a stock can remain irrationally valued for a long time. The fundamental investor knows this well.

2. *Global economic/ financial crisis*

A global economic/financial crisis would inevitably weigh down all equity markets, regardless of their valuation. However, we believe that, relatively speaking, the Orphan Companies market could outperform in such a crisis.

3. *Significant devaluation of the yen (if hedging fails)*

We see this as a positive event for Japanese equity in the medium term although volatility could increase. In addition, our portfolio will be partly hedged (for the portion of companies exposed only to the domestic market).

OPPORTUNITIES:

1) Broker Coverage

Analyst coverage is an essential tool for attracting the interest of certain institutional investors and, as a result, increasing the liquidity and valuations of orphan companies. An initiation of coverage by a broker can lead to the rediscovery of unfairly forgotten companies, helping to close significant discounts to peers and their fair value.

It must be said that a large proportion of small- and mid-cap companies lost their coverage after the 2008 crisis, which resulted in many brokerage houses cutting costs not only in Japan, but also in other developed countries. In addition, smaller companies, with the aim of reducing costs, have in many cases terminated hedging or market making contracts on the stock. However, this trend is already changing with brokers increasing their hedging after years of positive markets and the increased openness of the management of smaller Japanese companies to the market, confirmed by the significant effort made by many of them to be listed on the primary segment. However, this is an early trend that should be seized upon now.

2) They are acquired by competitors or withdrawn from the market by their controlling shareholder

The extremely sacrificial levels at which Orphan Companies are quoted imply that they can be easily acquired or bought by competitors or withdrawn from the market by their controlling shareholder, with the possibility of realising significant returns.

3) Increase the return for shareholders, in terms of dividends or buybacks

There is HUGE scope to increase the return to shareholders, while maintaining the extremely strong financial position. Added to this is the opportunity to reduce the capital invested in non-strategic listed equity investments, which could be easily liquidated in the market to further increase cash levels and the return of capital to shareholders.

4) Japanese market rerating linked to new leadership and/or yen devaluation

In recent years, Japan's leadership has changed frequently. After Shinzo Abe's eight years of leadership, the role of prime minister passed to Yoshihide Suga in 2020 and now it has changed again to Fumio Kishida in 2021, a conservative who nevertheless promises important reforms that could act as a catalyst for an acceleration of economic growth.

The devaluation of the yen would greatly benefit companies exposed to foreign markets, as it would make their products more competitive. A large proportion of Japanese companies derive a significant share of their revenues from exports and would therefore benefit.

There are several reasons to think about a yen devaluation. Please find enclosed an excerpt from our newsletter which discusses this topic in more detail: The Japanese economy has remained in deflation despite 30 years of super-expansionary fiscal and monetary policies. Public debt is huge, exceeding 2.5 times GDP. It reached 100% of GDP in the late 1990s and more than doubled over the next 20 years. More than 40% of public debt and half of Japanese government bond issues are in the hands of the Bank of Japan (BoJ), which, by not sterilising purchases, is effectively monetising the debt. Historically, monetising government debt has always led to significant currency devaluations. However, the yen remains strong. It is being driven by US and Chinese purchases and supported academically by exchange rate valuation methodologies that are not always effective, mainly taking into account the inflation differential. Both by major research houses such as JPM, Credit Suisse and GS, and by various international institutions such as the IMF, the JPY is considered undervalued against the US\$. As mentioned, the calculation is based on valuation methodologies that mostly use the inflation differential of the various countries. As Japan has been in deflation for 30 years, it is clear that its exchange rate is overvalued as a result. However, financial theory has to stop when faced with unknown and non-recurring facts (such as the constant deflationary state Japan is in) and should be able to be more flexible. However, this does not seem to interest or want to interest at the moment.

Applying the above valuation methodologies to the JPY and assuming that Japan continues to remain in a state of deflation and economic stagnation, it appears that its exchange rate must continue to appreciate indefinitely. Thus leading to more stagnation and deflation. All the way to where? Depression? And then what? In the real world, in order to avoid depression (and thus default) Japan applies constantly expansionary fiscal policies that increase public debt. Public debt which is methodically bought and monetised by the BoJ (actually the BoJ does not write it off and therefore does not formally monetise it for now, but by not sterilising the money supply it is as if it did). This factor, the monetisation of debt, is not taken into account by the classical methodologies of exchange rate evaluation.

Let us try, in a simplified way, to incorporate it. Let us take the "theoretical" USD/JPY exchange rate using an average of the most widely used classical methodologies (EER - Effective Exchange Rate and PPP - Purchase Power Parity), which is around 100 US\$ per US\$. Let us now dilute it, considering the 45% or so of public debt held by the BoJ, which is equivalent to 35% of Japan's M3 monetary base. Applying a 35% "dilution discount" to the exchange rate, we would arrive at a US\$-JPY ratio of 1:135. Around 20% below current levels (1:113). A devaluation would allow the country to recover and make its debt, which is not yet in the BoJ's hands, sustainable, then lay the foundations for a gradual normalisation of the exchange rate. The sooner the rebalancing takes place, the lower the risk of a violent and exaggerated adjustment.

The JPY is called the "widow maker" in the financial market, referring to the number of traders who fell victim to the seemingly easy trade of betting on the devaluation of the Japanese currency, only to find themselves with large losses and the need to close out their positions. But what would happen if the JPY depreciated? Today, much of Japan's manufacturing output is concentrated in outlet countries. For this production, the benefit of a devaluation would only be in the higher value of profits made abroad. However, the production of high-tech goods is still in Japan. Generally, for a 10% devaluation of the JPY, Japanese industrial companies benefit from profits ranging from about 5% to more than 30%, which is not insignificant. In addition, devaluation would inevitably lead to greater consumption of domestic goods, a greater flow of tourists and more investment from abroad. A gradual but significant devaluation, around 20-25% from current levels, would bring back some inflation in the country, some optimism among citizens and an explosion in the stock market, perhaps the most undervalued in the world. Inflation and growth would also have a beneficial effect on the heavy public debt, making it gradually sustainable. Moreover, almost half of that debt, the debt held by the BoJ, could in fact be written off (and would set an interesting precedent for Europe and the US as well). After so much suffering, the Japanese situation must be put right and the mistakes made at the Plaza Hotel in 1985 at least partially corrected."

5) The end of deflation would create positive spin

The fiscal policies promoted in the wake of Covid, investments linked to the energy transition and the domestic relocation of many manufacturing activities are triggering a process that will inevitably put an end to deflation in this country, one of the causes of the downward spiral in consumption and demographics. The end of deflation in Japan could mark the beginning of a growth phase after more than 30 years of stagnation. This would have dramatic repercussions on the stock market of this country, which is currently by far the most undervalued in the West. And clearly this would put an end to the anomaly represented by the Orphan Companies.

The strong undervaluation of assets, resulting from the high level of cash and high tangible assets relative to capitalisation, greatly reduces a lasting loss of invested capital.

• Valuation Gap report

At the launch of the fund, and on an annual basis, NicheAM will provide a document assessing the gap between the market valuation of the fund's portfolio and its intrinsic value.

This document will be published on NicheAM's website at the launch of the fund and by the end of the first quarter of each subsequent year. Should the valuation gap change significantly during the year, NicheAM will provide an update which will be published on its website.

Line by line application methodology

The fundamental upside of each individual stock in the portfolio at the time of the analysis will be presented, based on a homogeneous approach presented below.

Systematic, coherent and extremely stringent approach

Orphan Companies in the portfolio will be valued using a strict value approach.

Profitable companies - non-financial - will be valued on the basis of Price / Earnings targets ranging from 7x, 9x and 11x, depending on the medium and long term growth profile of the company, assuming a return of earnings to pre-Covid19 level, obviously in the absence of structural changes in their profitability.

Figure 56: Sensitivity analysis of expected earnings growth rate Vs Price Earnings ratio used for valuation purposes

Price / Earnings	Company growth profile	Mid to long term expected earnings growth
8x	declining to stable business profiles	Negative to 0%
10x	stable to slow growing business profile	0% to 3%
12x	slow to healthy growing business profile	Above 3%

Source: NicheAM

The return of excess liquidity to shareholders was then assumed, i.e. a debt-free balance sheet. In terms of liquidity, we also consider the return of financial investments to shareholders and the difference between trade receivables and trade payables. If the company has significant value in buildings and land, these will be valued at 0.3x and 1.0x their gross value, respectively.

Non-profitable - non-financial - companies are valued using the Sum of Parts method according to their potential liquidation value, as presented below:

Figure 57: Sum-of-Parts valuation of non-profitable companies

+0.1x sales
 + Cash – Financial Debt
 + Financial investments
 + Trade Receivable – Trade payables
 - Other current and non-current Liabilities
 + 50% inventories @ book value
 + 50% fixed asset @ book value (i.e., depreciated)

Fonte: NicheAM

If a significant change is made to the method indicated, adequate justification must be given (litigation risks, trademarks/patents, real estate value underestimated from book values, etc).

For the financial sector, insurance companies will be valued using a P/BVT of 0.6x, minus the resources needed to bring the solvency ratio (SMR) above 150%; banking companies at a P/BVT of 0.4x, minus the resources needed to bring the Capital Adequacy Ratios to 9% according to Japanese standards.

Figure 58: Extract from a summary table showing the upside of securities in the portfolio

Company	Ticker	Sector	Last Price	Last price €	Intrinsic Value	Upside / (Downside) to current price
TOYO SEIKAN HL/d	5901.t	Materials	1319	9,9	2609	98%
TOPPAN PRINTIN/d	7911.T	Industrials	1852	14,0	4441	140%
PACIFIC METALS/d	5541.T	Materials	2147	16,2	4583	113%
TS TECH/d	7313.T	Consumer Discretionary	1512	11,4	3862	155%
MIRAIT HOLDING/d	1417.T	Industrials	2175	16,4	4080	88%
HACHIJUNI BANK/d	8359.T	Financials	394	3,0	911	131%
TOAGOSEI/d	4045.T	Materials	1278	9,6	2247	76%
SHIBAURA MACHI/d	6104.T	Industrials	2624	19,8	4080	55%
SUMI MITSU CON/d	1821.T	Industrials	492	3,7	1535	212%
YACHIYO INDUST/d	7298.T	Consumer Discretionary	960	7,2	3455	260%
TOYO TANSO/d	5310.T	Industrials	3000	22,6	4786	60%
DIGITAL HLDG/d	2389.t	Communication Services	1805	13,6	3334,8	85%

Source: NicheAM

Portfolio upside summary in absolute terms

The upside of the portfolio will be determined on the basis of the upside determined for each individual security, taking into account their weight in the portfolio.

A discount will then be applied to take account of the average cash held in the portfolio, in order to maintain adequate management flexibility, especially in critical market phases, which may be quantified at around 15%.

A further prudential discount may be applied by the fund manager in consideration of possible valuation adjustments for the securities in the portfolio.

Figure 59: Example of portfolio upside determination

# stocks in the portfolio	75
Portfolio Valuation upside @ 21/10/2021	+249%
Discount applied for the average cash in portfolio	(15%)
Prudential discount applied by the IM	(20%)
Portfolio upside (valuation Gap)	+169%

Source: NicheAM

Determining the portfolio's average metrics relative to the market

Due to the Value/Deep Value style of the fund's strategy, the portfolio will be characterised on average by multiples at a discount to the market on at least one of the following metrics: P/E and/or P/BV and/or EV/Sales and/or EV/EBITDA and/or Dividend Yield.

Figure 61: Example of the presentation of portfolio metrics against an equity index

	EV/EBITDA '20	P/E '20	P/BV '20	P/BVT '20
Japanese Orphan Companies Engagement	2.4x *	7.3x **	0.55x	0.56x
MSCI World	n.a.	22.9x	3.20x	n.a.

* without taking into consideration the financial investments and the NWC Adjustments

** average PE ex firms appraised with liquidation value approach

Source: Niche AM, Thomson Reuters, MSCI

APPENDIX

APPENDIX 1: TABLE 4 NPL FROM 2002 TO 2021, BANK OF JAPAN

Table 1 Transition of Loans Based on the Financial Reconstruction Act

Metric	Region A Performance										Region B Performance										Region C Performance										Region D Performance									
	Q1	Q2	Q3	Q4	YTD	Q1	Q2	Q3	Q4	YTD	Q1	Q2	Q3	Q4	YTD	Q1	Q2	Q3	Q4	YTD	Q1	Q2	Q3	Q4	YTD	Q1	Q2	Q3	Q4	YTD										
Revenue (M\$)	120	130	140	150	540	110	120	130	140	500	90	100	110	120	420	80	90	100	110	380	70	80	90	100	340	60	70	80	90	260										
Profit (M\$)	30	35	40	45	150	25	30	35	40	130	20	25	30	35	110	15	20	25	30	90	10	15	20	25	70	5	10	15	20	50										
Units Sold (K)	1500	1600	1700	1800	6600	1400	1500	1600	1700	5200	1300	1400	1500	1600	4800	1200	1300	1400	1500	4400	1100	1200	1300	1400	4000	1000	1100	1200	1300	3600										
Customer Sat.	85	86	87	88	86.5	84	85	86	87	85.5	83	84	85	86	84.5	82	83	84	85	83.5	81	82	83	84	82.5	80	81	82	83	81.5										
Employee Ret.	92	93	94	95	93.5	90	91	92	93	91.5	88	89	90	91	89.5	86	87	88	89	87.5	84	85	86	87	85.5	82	83	84	85	83.5										
Market Share (%)	15	16	17	18	16.5	14	15	16	17	15.5	13	14	15	16	14.5	12	13	14	15	13.5	11	12	13	14	12.5	10	11	12	13	11.5										
ROI (%)	25	26	27	28	26.5	23	24	25	26	24.5	21	22	23	24	22.5	19	20	21	22	20.5	17	18	19	20	18.5	15	16	17	18	16.5										
Net Income (M\$)	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68	12	14	16	18	50	8	10	12	14	44										
EBITDA (M\$)	25	27	29	31	112	22	24	26	28	100	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68										
Operating Exp. (M\$)	90	95	100	105	390	85	90	95	100	370	75	80	85	90	330	65	70	75	80	280	55	60	65	70	210	45	50	55	60	160										
CapEx (M\$)	10	11	12	13	46	9	10	11	12	42	8	9	10	11	38	7	8	9	10	34	6	7	8	9	30	5	6	7	8	26										
Financing Exp. (M\$)	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20										
Depreciation (M\$)	15	16	17	18	66	14	15	16	17	62	13	14	15	16	58	12	13	14	15	54	11	12	13	14	50	10	11	12	13	44										
Interest Expense (M\$)	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32										
Income Tax (M\$)	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48										
Net Income (M\$)	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68	12	14	16	18	50	8	10	12	14	44										
EBITDA (M\$)	25	27	29	31	112	22	24	26	28	100	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68										
Operating Exp. (M\$)	90	95	100	105	390	85	90	95	100	370	75	80	85	90	330	65	70	75	80	280	55	60	65	70	210	45	50	55	60	160										
CapEx (M\$)	10	11	12	13	46	9	10	11	12	42	8	9	10	11	38	7	8	9	10	34	6	7	8	9	30	5	6	7	8	26										
Financing Exp. (M\$)	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20										
Depreciation (M\$)	15	16	17	18	66	14	15	16	17	62	13	14	15	16	58	12	13	14	15	54	11	12	13	14	50	10	11	12	13	44										
Interest Expense (M\$)	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32										
Income Tax (M\$)	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48										
Net Income (M\$)	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68	12	14	16	18	50	8	10	12	14	44										
EBITDA (M\$)	25	27	29	31	112	22	24	26	28	100	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68										
Operating Exp. (M\$)	90	95	100	105	390	85	90	95	100	370	75	80	85	90	330	65	70	75	80	280	55	60	65	70	210	45	50	55	60	160										
CapEx (M\$)	10	11	12	13	46	9	10	11	12	42	8	9	10	11	38	7	8	9	10	34	6	7	8	9	30	5	6	7	8	26										
Financing Exp. (M\$)	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20										
Depreciation (M\$)	15	16	17	18	66	14	15	16	17	62	13	14	15	16	58	12	13	14	15	54	11	12	13	14	50	10	11	12	13	44										
Interest Expense (M\$)	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32										
Income Tax (M\$)	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48										
Net Income (M\$)	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68	12	14	16	18	50	8	10	12	14	44										
EBITDA (M\$)	25	27	29	31	112	22	24	26	28	100	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68										
Operating Exp. (M\$)	90	95	100	105	390	85	90	95	100	370	75	80	85	90	330	65	70	75	80	280	55	60	65	70	210	45	50	55	60	160										
CapEx (M\$)	10	11	12	13	46	9	10	11	12	42	8	9	10	11	38	7	8	9	10	34	6	7	8	9	30	5	6	7	8	26										
Financing Exp. (M\$)	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20										
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Net Income (M\$)	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68	12	14	16	18	50	8	10	12	14	44										
EBITDA (M\$)	25	27	29	31	112	22	24	26	28	100	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68										
Operating Exp. (M\$)	90	95	100	105	390	85	90	95	100	370	75	80	85	90	330	65	70	75	80	280	55	60	65	70	210	45	50	55	60	160										
CapEx (M\$)	10	11	12	13	46	9	10	11	12	42	8	9	10	11	38	7	8	9	10	34	6	7	8	9	30	5	6	7	8	26										
Financing Exp. (M\$)	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20										
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Income Tax (M\$)	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48										
Net Income (M\$)	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68	12	14	16	18	50	8	10	12	14	44										
EBITDA (M\$)	25	27	29	31	112	22	24	26	28	100	20	22	24	26	92	18	20	22	24	84	16	18	20	22	76	14	16	18	20	68										
Operating Exp. (M\$)	90	95	100	105	390	85	90	95	100	370	75	80	85	90	330	65	70	75	80	280	55	60	65	70	210	45	50	55	60	160										
CapEx (M\$)	10	11	12	13	46	9	10	11	12	42	8	9	10	11	38	7	8	9	10	34	6	7	8	9	30	5	6	7	8	26										
Financing Exp. (M\$)	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20	5	5	5	5	20										
Depreciation (M\$)	15	16	17	18	66	14	15	16	17	62	13	14	15	16	58	12	13	14	15	54	11	12	13	14	50	10	11	12	13	44										
Interest Expense (M\$)	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32	8	8	8	8	32										
Income Tax (M\$)	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12	48	12	12	12	12																

Japan's Corporate Governance Code

In this Corporate Governance Code, “corporate governance” means a structure for transparent, fair, timely and decisive decision-making by companies, with due attention to the needs and perspectives of shareholders and also customers, employees and local communities. This Corporate Governance Code establishes fundamental principles for effective corporate governance at listed companies in Japan. It is expected that the Code’s appropriate implementation will contribute to the development and success of companies, investors and the Japanese economy as a whole through individual companies’ self-motivated actions so as to achieve sustainable growth and increase corporate value over the mid- to long-term.

General Principles

Securing the Rights and Equal Treatment of Shareholders

1. Companies should take appropriate measures to fully secure shareholder rights and develop an environment in which shareholders can exercise their rights appropriately and effectively. In addition, companies should secure effective equal treatment of shareholders. Given their particular sensitivities, adequate consideration should be given to the issues and concerns of minority shareholders and foreign shareholders for the effective exercise of shareholder rights and effective equal treatment of shareholders.

Appropriate Cooperation with Stakeholders Other Than Shareholders

2. Companies should fully recognize that their sustainable growth and the creation of mid- to long-term corporate value are brought as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities. As such, companies should endeavor to appropriately cooperate with these stakeholders. The board and the management should exercise their leadership in establishing a corporate culture where the rights and positions of stakeholders are respected and sound business ethics are ensured.

Ensuring Appropriate Information Disclosure and Transparency

3. Companies should appropriately make information disclosure in compliance with the relevant laws and regulations but should also strive to actively provide information beyond that required by law. This includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and business issues, risk, and governance. The board should recognize that disclosed information will serve as the basis for constructive dialogue with shareholders, and therefore ensure that such information, particularly non-financial information, is accurate, clear and useful.

Responsibilities of the Board

4. Given its fiduciary responsibility and accountability to shareholders, in order to promote sustainable corporate growth and the increase of corporate value over the mid- to long-term and enhance earnings power and capital efficiency, the board should appropriately fulfill its roles and responsibilities, including:

- (1) Setting the broad direction of corporate strategy;
- (2) Establishing an environment where appropriate risk-taking by the senior management is supported; and
- (3) Carrying out effective oversight of directors and the management (including shikkoyaku and so-called shikkoyakuin) from an independent and objective standpoint.

Such roles and responsibilities should be equally and appropriately fulfilled regardless of the form of corporate organization – i.e., Company with Kansayaku Board (where a part of these roles and responsibilities are performed by kansayaku and the kansayaku board), Company with Three Committees (Nomination, Audit and Remuneration), or Company with Supervisory Committee.

Dialogue with Shareholders

5. In order to contribute to sustainable growth and the increase of corporate value over the mid- to long-term, companies should engage in constructive dialogue with shareholders even outside the general shareholder meeting. During such dialogue, senior management and directors, including outside directors, should listen to the views of shareholders and pay due attention to their interests and concerns, clearly explain business policies to shareholders in an understandable manner so as to gain their support, and work for developing a balanced understanding of the positions of shareholders and other stakeholders and acting accordingly.

Section 1: Securing the Rights and Equal Treatment of Shareholders

General Principle 1

Companies should take appropriate measures to fully secure shareholder rights and develop an environment in which shareholders can exercise their rights appropriately and effectively. In addition, companies should secure effective equal treatment of shareholders. Given their particular sensitivities, adequate consideration should be given to the issues and concerns of minority shareholders and foreign shareholders for the effective exercise of shareholder rights and effective equal treatment of shareholders.

Notes

Companies have various stakeholders, including shareholders. Without appropriate cooperation with these stakeholders, it would be difficult for companies to achieve sustainable growth. Suppliers of capital are an important cornerstone, and shareholders are the primary starting point for corporate governance discipline. Companies should secure appropriate cooperation with shareholders and strive toward the achievement of sustainable growth by fully securing shareholder rights and providing for the smooth exercise thereof. In addition, the Companies Act requires companies to equally treat shareholders based on the class and number of shares they hold. Gaining broad confidence of shareholders that they receive equal treatment will also contribute to strengthening support from the suppliers of capital.

Principle 1.1 Securing the Rights of Shareholders

Companies should take appropriate measures to fully secure shareholder rights, including voting rights at the general shareholder meeting.

Supplementary Principles

1.1.1 When the board recognizes that a considerable number of votes have been cast against a proposal by the company and the proposal was approved, it should analyze the reasons behind opposing votes and why many shareholders opposed, and should consider the need for shareholder dialogue and other measures.

1.1.2 When proposing to shareholders that certain powers of the general shareholder meeting be delegated to the board, companies should consider whether the board is adequately constituted to fulfill its corporate governance roles and responsibilities. If a company determines that the board is indeed adequately constituted, then it should recognize that

such delegation may be desirable from the perspectives of agile decision-making and expertise in business judgment.

1.1.3 Given the importance of shareholder rights, companies should ensure that the exercise of shareholder rights is not impeded. In particular, adequate consideration should be given to the special rights that are recognized for minority shareholders with respect to companies and their officers, including the right to seek an injunction against illegal activities or the right to file a shareholder lawsuit, since the exercise of these rights tend to be prone to issues and concerns.

Principle 1.2 Exercise of Shareholder Rights at General Shareholder Meetings

Companies should recognize that general shareholder meetings are an opportunity for constructive dialogue with shareholders and should therefore take appropriate measures to ensure the exercise of shareholder rights at such meetings.

Supplementary Principles

1.2.1 Companies should provide accurate information to shareholders as necessary in order to facilitate appropriate decision-making at general shareholder meetings.

1.2.2 While ensuring the accuracy of content, companies should strive to send convening notices for general shareholder meetings early enough to give shareholders sufficient time to consider the agenda. During the period between the board approval of convening the general shareholder meeting and sending the convening notice, information included in the convening notice should be disclosed by electronic means such as through TDnet1 or on the company's website.

1.2.3 The determination of the date of the general shareholder meeting and any associated dates should be made in consideration of facilitating sufficient constructive dialogue with shareholders and ensuring the accuracy of information necessary for such dialogue.

1.2.4 Bearing in mind the number of institutional and foreign shareholders, companies should take steps for the creation of an infrastructure allowing electronic voting, including the use of the Electronic Voting Platform, and the provision of English translations of the convening notices of general shareholder meeting. In particular, companies listed on the Prime Market should make the Electronic Voting Platform available, at least to institutional investors.

1.2.5 In order to prepare for cases where institutional investors who hold shares in street name express an interest in advance of the general shareholder meeting in attending the

general shareholder meeting or exercising voting rights, companies should work with the trust bank (shintaku ginko) and/or custodial institutions to

Principle 1.3 Basic Strategy for Capital Policy

Because capital policy may have a significant effect on shareholder returns, companies should explain their basic strategy with respect to their capital policy

Principle 1.4 Cross-Shareholdings

When companies hold shares of other listed companies as cross-shareholdings, they should disclose their policy with respect to doing so, including their policies regarding the reduction of cross-shareholdings. In addition, the board should annually assess whether or not to hold each individual cross-shareholding, specifically examining whether the purpose is appropriate and whether the benefits and risks from each holding cover the company's cost of capital. The results of this assessment should be disclosed. Companies should establish and disclose specific standards with respect to the voting rights as to their cross-shareholdings, and vote in accordance with the standards.

Supplementary Principles

1.4.1 When cross-shareholders (i.e., shareholders who hold a company's shares for the purpose of cross-shareholding) indicate their intention to sell their shares, companies should not hinder the sale of the cross-held shares by, for instance, implying a possible reduction of business transactions.

1.4.2 Companies should not engage in transactions with cross-shareholders which may harm the interests of the companies or the common interests of their shareholders by, for instance, continuing the transactions without carefully examining the underlying economic rationale.

Principle 1.5 Anti-Takeover Measures

Anti-takeover measures must not have any objective associated with entrenchment of the management or the board. With respect to the adoption or implementation of anti-takeover measures, the board and kansayaku³ should carefully examine their necessity and rationale in light of their fiduciary responsibility to shareholders, ensure appropriate procedures, and provide sufficient explanation to shareholders

Supplementary Principle

1.5.1 In case of a tender offer, companies should clearly explain the position of the board, including any counteroffers, and should not take measures that would frustrate shareholder rights to sell their shares in response to the tender offer.

Principle 1.6 Capital Policy that May Harm Shareholder Interests

With respect to a company's capital policy that results in the change of control or in significant dilution, including share offerings and management buyouts, the board and kansayaku should, in order not to unfairly harm the existing shareholders' interests, carefully examine the necessity and rationale from the perspective of their fiduciary responsibility to shareholders, should ensure appropriate procedures, and provide sufficient explanation to shareholders.

Principle 1.7 Related Party Transactions

When a company engages in transactions with its directors or major shareholders (i.e., related party transactions), in order to ensure that such transactions do not harm the interests of the company or the common interests of its shareholders and prevent any concerns with respect to such harm, the board should establish appropriate procedures beforehand in proportion to the importance and characteristics of the transaction. In addition to their use by the board in approving and monitoring such transactions, these procedures should be disclosed.

Section 2: Appropriate Cooperation with Stakeholders Other Than Shareholders

General Principle 2

Companies should fully recognize that their sustainable growth and the creation of mid- to long-term corporate value are brought about as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities. As such, companies should endeavor to appropriately cooperate with these stakeholders. The board and the management should exercise their leadership in establishing a corporate culture where the rights and positions of stakeholders are respected and sound business ethics are ensured.

Notes

Companies have a variety of important stakeholders besides shareholders. These stakeholders include internal parties such as employees and external parties such as customers, business partners and creditors. In addition, local communities form the foundation for the on-going business activities of companies. Companies should fully recognize that appropriate cooperation with these stakeholders

is indispensable in achieving sustainable growth and increasing corporate value over the mid- to long-term. Moreover, given that the Sustainable Development Goals (SDGs) were adopted at the United Nations Summit and the number of organizations supporting the recommendation of the FSB's Task Force on Climate-related Financial Disclosure (TCFD) has increased, there is a growing awareness that sustainability (mid-to long-term sustainability including ESG factors) is an important management issue from the perspective of increasing midto long-term corporate value. In light of this, it is important for Japanese companies to further promote positive and proactive responses to sustainability issues. The appropriate actions of companies based on the recognition of their stakeholder responsibilities will benefit the entire economy and society, which will in turn contribute to producing further benefits to companies, thereby creating a virtuous cycle.

Principle 2.1 Business Principles as the Foundation of Corporate Value Creation Over the Mid- to Long-Term

Guided by their position concerning social responsibility, companies should undertake their businesses in order to create value for all stakeholders while increasing corporate value over the mid-to long-term. To this end, companies should draft and maintain business principles that will become the basis for such activities.

Principle 2.2 Code of Conduct

Companies should draft and implement a code of conduct for employees in order to express their values with respect to appropriate cooperation with and serving the interests of stakeholders and carrying out sound and ethical business activities. The board should be responsible for drafting and revising the code of conduct, and should ensure its compliance broadly across the organization, including the front line of domestic and global operations.

Supplementary Principle

2.2.1 The board should review regularly (or where appropriate) whether or not the code of conduct is being widely implemented. The review should focus on the substantive assessment of whether the company's corporate culture truly embraces the intent and spirit of the code of conduct, and not solely on the form of implementation and compliance.

Principle 2.3 Sustainability Issues, Including Social and Environmental Matters

Companies should take appropriate measures to address sustainability issues, including social and environmental matters.

Supplementary Principle

2.3.1. The board should recognize that dealing with sustainability issues, such as taking care of climate change and other global environmental issues, respect of human rights, fair and appropriate treatment of the workforce including caring for their health and working environment, fair and reasonable transactions with suppliers, and crisis management for natural disasters, are important management issues - 11 - that can lead to earning opportunities as well as risk mitigation, and should further consider addressing these matters positively and proactively in terms of increasing corporate value over the mid-to long-term.

Principle 2.4 Ensuring Diversity, Including Active Participation of Women

Companies should recognize that the existence of diverse perspectives and values reflecting a variety of experiences, skills and characteristics is a strength that supports their sustainable growth. As such, companies should promote diversity of personnel, including the active participation of women.

Supplementary Principle

2.4.1 Companies should present their policies and voluntary and measurable goals for ensuring diversity in the promotion to core human resources, such as the promotion of women, foreign nationals and midcareer hires to middle managerial positions, as well as disclosing their status. In addition, in light of the importance of human resource strategies for increasing corporate value over the mid-to long-term, companies should present its policies for human resource development and internal environment development to ensure diversity, as well as the status of their implementation.

Principle 2.5 Whistleblowing

Companies should establish an appropriate framework for whistleblowing such that employees can report illegal or inappropriate behavior, disclosures, or any other serious concerns without fear of suffering from disadvantageous treatment. Also, the framework should allow for an objective assessment and appropriate response to the reported issues, and the board should be responsible for both establishing this framework, and ensuring and monitoring its enforcement.

Supplementary Principle

2.5.1 As a part of establishing a framework for whistleblowing, companies should establish a point of contact that is independent of the management (for example, - 12 - a panel consisting of outside directors⁴ and outside kansayaku⁵). In addition, rules should be established to secure the confidentiality of the information provider and prohibit any disadvantageous treatment.

Principle 2.6 Roles of Corporate Pension Funds as Asset Owners

Because the management of corporate pension funds impacts stable asset formation for employees and companies' own financial standing, companies should take and disclose measures to improve human resources and operational practices, such as the recruitment or assignment of qualified persons, in order to increase the investment management expertise of corporate pension funds (including stewardship activities such as monitoring the asset managers of corporate pension funds), thus making sure that corporate pension funds perform their roles as asset owners. Companies should ensure that conflicts of interest which could arise between pension fund beneficiaries and companies are appropriately managed.

Section 3: Ensuring Appropriate Information Disclosure and Transparency

General Principle 3

Companies should appropriately make information disclosure in compliance with the relevant laws and regulations but should also strive to actively provide information beyond that required by law. This includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and business issues, risk and governance. The board should recognize that disclosed information will serve as the basis for constructive dialogue with shareholders, and therefore ensure that such information, particularly non-financial information, is accurate, clear and useful.

Notes

Companies are legally required to disclose a wide range of information. The timely and appropriate disclosure of information in accordance with the relevant laws and regulations is essential for investor protection and securing market confidence. The board, kansayaku, the kansayaku board 6 and external auditors all bear an important responsibility in this regard, starting with the establishment of an appropriate internal control system as to financial information. Companies should actively strive to provide information other than what is required by laws and regulations. It has been noted that while the quantitative part of financial statements of Japanese companies conform to a standard format and therefore excel with respect to comparability, non-financial information, such as financial standing, business strategies, risks and ESG (environmental, social and governance) matters, is often boilerplate and lacking in detail, therefore less valuable. The board should actively commit to ensure that disclosed information, including non-financial information, is as valuable and useful as possible. Irrespective of whether the disclosed information is required by law, the appropriate provision of

information is an effective means to develop a shared awareness and understanding with shareholders and other stakeholders, in particular given that as 6 Kansayaku board: See Notes to the General Principle 4. - 14 - outsiders they suffer from information asymmetry. Appropriate information disclosure will also contribute to constructive dialogue based on Japan's Stewardship Code.

Principle 3.1 Full Disclosure

In addition to making information disclosure in compliance with relevant laws and regulations, companies should disclose and proactively provide the information listed below (along with the disclosures specified by the principles of the Code) in order to enhance transparency and fairness in decision-making and ensure effective corporate governance:

- i) Company objectives (e.g., business principles), business strategies and business plans;
- ii) Basic views and guidelines on corporate governance based on each of the principles of the Code;
- iii) Board policies and procedures in determining the remuneration of the senior management and directors;
- iv) Board policies and procedures in the appointment/dismissal of the senior management and the nomination of directors and kansayaku candidates; and
- v) Explanations with respect to the individual appointments/dismissals and nominations based on iv).

Supplementary Principles

3.1.1 These disclosures, including disclosures in compliance with relevant laws and regulations, should add value for investors, and the board should ensure that information is not boilerplate or lacking in detail.

3.1.2 Bearing in mind the number of foreign shareholders, companies should, to the extent reasonable, take steps for providing English language disclosures. In particular, companies listed on the Prime Market should disclose and provide necessary information in their disclosure documents in English.

3.1.3 Companies should appropriately disclose their initiatives on sustainability when disclosing their management strategies. They should also provide information on investments in human capital and intellectual properties in an understandable - 15 - and specific manner, while being conscious of the consistency with their own management strategies and issues. In particular, companies listed on the Prime Market should collect and analyze the necessary data on the impact of climate change-related risks and earning opportunities on their business activities and profits,

and enhance the quality and quantity of disclosure based on the TCFD recommendations, which are an internationally well-established disclosure framework, or an equivalent framework.

Principle 3.2 External Auditors

External auditors and companies should recognize the responsibility that external auditors owe toward shareholders and investors and take appropriate steps to secure the proper execution of audits.

Supplementary Principles

3.2.1 The kansayaku board should, at minimum, ensure the following:

- i) Establish standards for the appropriate selection of external auditor candidates and proper evaluation of external auditors; and
- ii) Verify whether external auditors possess necessary independence and expertise to fulfill their responsibilities.

3.2.2 The board and the kansayaku board should, at minimum, ensure the following:

- i) Give adequate time to ensure high quality audits;
- ii) Ensure that external auditors have access, such as via interviews, to the senior management including the CEO and the CFO;
- iii) Ensure adequate coordination between external auditors and each of the kansayaku (including attendance at the kansayaku board meetings), the internal audit department and outside directors; and - 16 - iv) Ensure that the company is constituted in the way that it can adequately respond to any misconduct, inadequacies or concerns identified by the external auditors.
- iv) Ensure that the company is constituted in the way that it can adequately respond to any misconduct, inadequacies or concerns identified by the external auditors.

Section 4: Responsibilities of the Board

General Principle 4

Given its fiduciary responsibility and accountability to shareholders, in order to promote sustainable corporate growth and the increase of corporate value over the mid to long-term and enhance earnings power and capital efficiency, the board should appropriately fulfil its roles and responsibilities, including:

- (1) Setting the broad direction of corporate strategy;
- (2) Establishing an environment where appropriate risk-taking by the senior management is supported; and
- (3) Carrying out effective oversight of directors and the management (including shikkoyaku and so-called shikkoyakuin) from an independent and objective standpoint.

Such roles and responsibilities should be equally and appropriately fulfilled regardless of the form of corporate organization – i.e., Company with Kansayaku Board (where a part of these roles and responsibilities are performed by kansayaku and the kansayaku board), Company with Three Committees (Nomination, Audit and Remuneration) or Company with Supervisory Committee.

Notes

Companies may choose one of three main forms of organizational structure under the Companies Act: Company with Kansayaku Board, Company with Three Committees (Nomination, Audit and Remuneration), or Company with Supervisory Committee. A Company with Kansayaku Board is a system unique to Japan in which certain governance functions are assumed by the board, kansayaku and the kansayaku board. Under this system, kansayaku audit the performance of duties by directors and the management and have investigation power by law. Also, to secure both independence and high-level information gathering power, not less than half of kansayaku, as appointed at the general shareholder meeting, must be outside kansayaku, and at least one full-time kansayaku must also be appointed. The latter two forms of organizational structure are similar to companies in other countries where committees are established under the board and assigned certain responsibilities with the aim of strengthening monitoring functions. Irrespective of which form of organizational structure is adopted, what is important is that the various institutions within the company effectively and fully execute their responsibilities through creativity and ingenuity. One of the major objectives of establishing the Code is to promote transparent, fair, timely and decisive decision-making by Japanese companies. The possibility cannot be ruled out that, due to changes in the external environment or

other factors, a decision made by a company ultimately results in losses for the company. In such a circumstance, the reasonableness of the decision-making process at the time of the decision is generally considered an important factor in determining whether or not the management and directors should owe personal liability for damages. The Code includes principles and practices that are expected to contribute to such a reasonable decision-making process, and promote transparency, fairness, timeliness and decisiveness as well. Controlling shareholders should respect the common interests of the company and its shareholders and should not treat minority shareholders unfairly, and accordingly, companies with a controlling shareholder are required to develop a governance system to protect the interest of minority shareholders.

Principle 4.1 Roles and Responsibilities of the Board (1)

The board should view the establishment of corporate goals (business principles, etc.) and the setting of strategic direction as one major aspect of its roles and responsibilities. It should engage in constructive discussion with respect to specific business strategies and business plans, and ensure that major operational decisions are based on the company's strategic direction.

Supplementary Principles

4.1.1 The board should clearly specify its own decisions as well as both the scope and content of the matters delegated to the management and disclose a brief summary thereof.

4.1.2 Recognizing that a mid-term business plan (chuuki keiei keikaku) is a commitment to shareholders, the board and the senior management should do their best to achieve the plan. Should the company fail to deliver on its mid-term business plan, the reasons underlying the failure of achievement as well as the company's actions should be fully analyzed, an appropriate explanation should be given to shareholders, and analytic findings should be reflected in a plan for the ensuing years.

4.1.3 Based on the company objectives (business principles, etc.) and specific business strategies, the board should proactively engage in the establishment and implementation of a succession plan for the CEO and other top executives and appropriately oversee the systematic development of succession candidates, deploying sufficient time and resources.

Principle 4.2 Roles and Responsibilities of the Board (2)

The board should view the establishment of an environment that supports appropriate risk-taking by the senior management as a major aspect of its roles and responsibilities. It should welcome proposals from the management based on healthy entrepreneurship, fully examine such proposals from an

independent and objective standpoint with the aim of securing accountability, and support timely and decisive decision-making by the senior management when approved plans are implemented. Also, the remuneration of the management should include incentives such that it reflects mid- to long-term business results and potential risks, as well as promotes healthy entrepreneurship.

Supplementary Principle

4.2.1 The board should design management remuneration systems such that they operate as a healthy incentive to generate sustainable growth, and determine actual remuneration amounts appropriately through objective and transparent procedures. The proportion of management remuneration linked to mid- to longterm results and the balance of cash and stock should be set appropriately.

4.2.2 The board should develop a basic policy for the company's sustainability initiatives from the perspective of increasing corporate value over the mid- to long- term. In addition, in light of the importance of investments in human capital and intellectual properties, the board should effectively supervise the allocation of management resources, including such investments, and the implementation of business portfolio strategies to ensure that they contribute to the sustainable growth of the company.

Principle 4.3 Roles and Responsibilities of the Board (3)

The board should view the effective oversight of the management and directors from an independent and objective standpoint as a major aspect of its roles and responsibilities. It should appropriately evaluate company performance and reflect the evaluation in its assessment of the senior management. In addition, the board should engage in oversight activities in order to ensure timely and accurate information disclosure, and should establish appropriate internal control and risk management systems. Also, the board should appropriately deal with any conflict of interests that may arise between the company and its related parties, including the management and controlling shareholders.

Supplementary Principles

4.3.1 The board should ensure that the appointment and dismissal of the senior management are based on highly transparent and fair procedures via an appropriate evaluation of the company's business results.

4.3.2 Because the appointment/dismissal of the CEO is the most important strategic decision for a company, the board should appoint a qualified CEO through objective, timely, and transparent procedures, deploying sufficient time and resources.

4.3.3 The board should establish objective, timely, and transparent procedures such that a CEO is dismissed when it is determined, via an appropriate evaluation of the company's business results, that the CEO is not adequately fulfilling the CEO's responsibilities.

4.3.4 The establishment of effective internal control and proactive enterprise risk management systems has the potential to support sound risk-taking. The board should appropriately establish such systems on an enterprise basis and oversee the operational status, besides utilizing the internal audit department.

Principle 4.4 Roles and Responsibilities of Kansayaku and the Kansayaku Board

Kansayaku and the kansayaku board should bear in mind their fiduciary responsibilities to shareholders and make decisions from an independent and objective standpoint when executing their roles and responsibilities including the audit of the performance of directors' duties, appointment and dismissal of kansayaku and external auditors, and the determination of auditor remuneration. Although so-called "defensive functions," such as business and accounting audits, are part of the roles and responsibilities expected of kansayaku and the kansayaku board, in order to fully perform their duties, it would not be appropriate for kansayaku and the kansayaku board to interpret the scope of their function too narrowly, and they should positively and proactively exercise their rights and express their views at board meetings and to the management.

Supplementary Principle

4.4.1 Given that not less than half of the kansayaku board must be composed of outside kansayaku and that at least one full-time kansayaku must be appointed in accordance with the Companies Act, the kansayaku board should, from the perspective of fully executing its roles and responsibilities, increase its effectiveness through an organizational combination of the independence of the former and the information gathering power of the latter. In addition, kansayaku or the kansayaku board should secure cooperation with outside directors so that such directors can strengthen their capacity to collect information without having their independence jeopardized.

Principle 4.5 Fiduciary Responsibilities of Directors and Kansayaku

With due attention to their fiduciary responsibilities to shareholders, the directors, kansayaku and the management of companies should secure the appropriate cooperation with stakeholders and act in the interest of the company and the common interests of its shareholders.

Principle 4.6 Business Execution and Oversight of the Management

In order to ensure effective, independent and objective oversight of the management by the board, companies should consider utilizing directors who are neither involved in business execution nor have close ties with the management.

Principle 4.7 Roles and Responsibilities of Independent Directors

Companies should make effective use of independent directors⁹, taking into consideration the expectations listed below with respect to their roles and responsibilities:

- i) Provision of advice on business policies and business improvement based on their knowledge and experience with the aim to promote sustainable corporate growth and increase corporate value over the mid- to long-term;
- ii) Monitoring of the management through important decision-making at the board including the appointment and dismissal of the senior management;
- iii) Monitoring of conflicts of interest between the company and the management or controlling shareholders; and
- iv) Appropriately representing the views of minority shareholders and other stakeholders in the boardroom from a standpoint independent of the management and controlling shareholders.

Principle 4.8 Effective Use of Independent Directors

Independent directors should fulfill their roles and responsibilities with the aim of contributing to sustainable growth of companies and increasing corporate value over the mid- to long-term. Companies listed on the Prime Market should therefore appoint at least one-third of their directors as independent directors (two directors if listed on other markets) that sufficiently have such qualities. Irrespective of the above, if a company listed on the Prime Market believes it needs to appoint the majority of directors (at least one-third of directors if listed on other markets) as independent directors based on a broad consideration of factors such as the industry, company size, business characteristics, organizational structure and circumstances surrounding the company, it should appoint a sufficient number of independent directors.

Supplementary Principles

4.8.1 In order to actively contribute to discussions at the board, independent directors should endeavor to exchange information and develop a shared awareness among themselves from an independent and objective standpoint. Regular meetings consisting solely of independent directors (executive sessions) would be one way of achieving this.

4.8.2 Independent directors should endeavor to establish a framework for communicating with the management and for cooperating with kansayaku or the kansayaku board by, for example, appointing the lead independent director from among themselves.

4.8.3 Companies that have a controlling shareholder should either appoint at least one-third of their directors (the majority of directors if listed on the Prime Market) as independent directors who are independent of the controlling shareholder or establish a special committee composed of independent persons including independent director(s) to deliberate and review material transactions or actions that conflict with the interests of the controlling shareholder and minority shareholders.

Principle 4.9 Independence Standards and Qualification for Independent Directors

Boards should establish and disclose independence standards aimed at securing effective independence of independent directors, taking into consideration the independence criteria set by securities exchanges. The board should endeavor to select independent director candidates who are expected to contribute to frank, active and constructive discussions at board meetings.

Principle 4.10 Use of Optional Approach

In adopting the most appropriate organizational structure (as stipulated by the Companies Act) that is suitable for a company's specific characteristics, companies should employ optional approaches, as necessary, to further enhance governance functions

Supplementary Principle

4.10.1 If the organizational structure of a company is either Company with Kansayaku Board or Company with Supervisory Committee and independent directors do not compose a majority of the board, in order to strengthen the independence, objectivity and accountability of board functions on the matters of nomination (including succession plan) and remuneration of the senior management and directors, the company should seek appropriate involvement and advice from the committees, including from the perspective of gender and other diversity and skills, in the examination of such important matters as nominations and remuneration by

establishing an independent nomination committee and remuneration committee under the board, to which such committees make significant contributions. In particular, companies listed on the Prime Market should basically have the majority of the members of each committee be independent directors, and should disclose the mandates and roles of the committees, as well as the policy regarding the independence of the composition

Principle 4.11 Preconditions for Board and Kansayaku Board Effectiveness

The board should be well balanced in knowledge, experience and skills in order to fulfill its roles and responsibilities, and it should be constituted in a manner to achieve both diversity, including gender, international experience, work experience and age, and appropriate size. In addition, persons with appropriate experience and skills as well as necessary knowledge on finance, accounting, and the law should be appointed as kansayaku. In particular, at least one person who has sufficient expertise on finance and accounting should be appointed as kansayaku. The board should endeavor to improve its function by analyzing and evaluating effectiveness of the board as a whole.

Supplementary Principles

4.11.1 The board should identify the skills, etc. that it should have in light of its managing strategies, and have a view on the appropriate balance between knowledge, experience and skills of the board as a whole, and also on diversity and appropriate board size. Consistent with its view, the board should establish policies and procedures for nominating directors and disclose them along with the combination of skills, etc. that each director possesses in an appropriate form according to the business environment and business characteristics, etc., such as what is known as a "skills matrix." When doing so, independent director(s) with management experience in other companies should be included.

4.11.2 Outside directors, outside kansayaku, and other directors and kansayaku should devote sufficient time and effort required to appropriately fulfill their respective roles and responsibilities. Therefore, where directors and kansayaku also serve as directors, kansayaku or the management at other companies, such positions should be limited to a reasonable number and disclosed each year.

4.11.3 Each year the board should analyze and evaluate its effectiveness as a whole, taking into consideration the relevant matters, including the self-evaluations of each director. A summary of the results should be disclosed.

Principle 4.12 Active Board Deliberations

The board should endeavor to foster a climate where free, open and constructive discussions and exchanges of views take place, including the raising of concerns by outside directors.

Supplementary Principle

4.12.1 The board should ensure the following in relation to the operation of board meetings and should attempt to make deliberations active:

- i) Materials for board meetings are distributed sufficiently in advance of the meeting date;
- ii) In addition to board materials and as necessary, sufficient information is provided to directors by the company (where appropriate, the information should be organized and/or analyzed to promote easy understanding);
- iii) The schedule of board meetings for the current year and anticipated agenda items are determined in advance;
- iv) The number of agenda items and the frequency of board meetings are set appropriately; and
- v) Sufficient time for deliberations.

Principle 4.13 Information Gathering and Support Structure

In order to fulfill their roles and responsibilities, directors and kansayaku should proactively collect information, and as necessary, request the company to provide them with additional information. Also, companies should establish a support structure for directors and kansayaku, including providing sufficient staff. The board and the kansayaku board should verify whether information requested by directors and kansayaku is provided smoothly.

Supplementary Principles

4.13.1 Directors, including outside directors, should request the company to provide them with additional information, where deemed necessary from the perspective of contributing to transparent, fair, timely and decisive decision-making. In addition, kansayaku, including outside kansayaku, should collect information appropriately, including the use of their statutory investigation power.

4.13.2 Directors and kansayaku should consider consulting with external specialists at company expense, where they deem it necessary.

4.13.3 Companies should ensure coordination between the internal audit department, directors and kansayaku by establishing a system in which the internal audit department appropriately reports directly to the board and the kansayaku board in order for them to fulfill their functions. In addition, companies should take measures to adequately provide necessary information to outside directors and outside kansayaku. One example would be the appointment of an individual who is responsible for communicating and handling requests within the company such that the requests for information about the company by outside directors and outside kansayaku are appropriately processed.

Principle 4.14 Director and Kansayaku Training

New and incumbent directors and kansayaku should deepen their understanding of their roles and responsibilities as a critical governance body at a company, and should endeavor to acquire and update necessary knowledge and skills. Accordingly, companies should provide and arrange training opportunities suitable to each director and kansayaku along with financial support for associated expenses. The board should verify whether such opportunities and support are appropriately provided.

Supplementary Principles

4.14.1 Directors and kansayaku, including outside directors and outside kansayaku, should be given the opportunity when assuming their position to acquire necessary knowledge on the company's business, finances, organization and other matters, and fully understand the roles and responsibilities, including legal liabilities, expected of them. Incumbent directors should also be given a continuing opportunity to renew and update such knowledge as necessary.

4.14.2 Companies should disclose their training policy for directors and kansayaku

Section 5: Dialogue with Shareholders

General Principle 5

In order to contribute to sustainable growth and the increase of corporate value over the mid- to long-term, companies should engage in constructive dialogue with shareholders even outside the general shareholder meeting. During such dialogue, senior management and directors, including outside directors, should listen to the views of shareholders and pay due attention to their interests and concerns, clearly explain business policies to shareholders in an understandable manner so as to gain

their support, and work for developing a balanced understanding of the positions of shareholders and other stakeholders and acting accordingly

Notes

With the establishment of Japan's Stewardship Code, institutional investors are encouraged to engage in purposeful dialogue (engagement) based on the in-depth knowledge of investee companies and their business environment.

Regularly engaging in dialogue with shareholders to gain their understanding of specific business strategies and business plans and taking appropriate action when there are concerns are extraordinarily useful for companies to strengthen the foundations of management legitimacy and support their efforts to generate sustainable growth. Although the management and directors have opportunities to interact and exchange views with employees, business partners and financial institutions on a daily basis, these stakeholders are all creditors. In contrast, the management and directors typically have limited interactions with shareholders. If the senior management and directors give due attention to the views of shareholders through dialogue, they can absorb views and analyses of business management from the perspective of capital providers. Dialogue with shareholders should also inspire healthy entrepreneurship in the management and directors and thereby contribute to sustainable corporate growth.

Principle 5.1 Policy for Constructive Dialogue with Shareholders

Companies should, positively and to the extent reasonable, respond to the requests from shareholders to engage in dialogue (management meetings) so as to support sustainable growth and increase corporate value over the mid- to long-term. The board should establish, approve and disclose policies concerning the measures and organizational structures aimed at promoting constructive dialogue with shareholders.

Supplementary Principles

5.1.1 Taking the requests and interests of shareholders into consideration, to the extent reasonable, the senior management, directors, including outside directors, and kansayaku, should have a basic position to engage in dialogue (management meetings) with shareholders.

5.1.2 At minimum, policies for promoting constructive dialogue with shareholders should include the following:

- i) Appointing a member of the management or a director who is responsible for overseeing and ensuring that constructive dialogue takes place, including the matters stated in items ii) to v) below;
- ii) Measures to ensure positive cooperation between internal departments such as investor relations, corporate planning, general affairs, corporate finance, accounting and legal affairs with the aim of supporting dialogue;
- iii) Measures to promote opportunities for dialogue aside from individual meetings (e.g., general investor meetings and other IR activities);
- iv) Measures to appropriately and effectively relay shareholder views and concerns learned through dialogue to the senior management and the board; and
- v) Measures to control insider information when engaging in dialogue.

5.1.3 Companies should endeavor to identify their shareholder ownership structure as necessary, and it is desirable for shareholders to cooperate as much as possible in this process.

Principle 5.2 Establishing and Disclosing Business Strategies and Business Plans

When establishing and disclosing business strategies and business plans, companies should articulate their earnings plans and capital policies, and present targets for profitability and capital efficiency after accurately identifying the company's cost of capital. Also, companies should provide explanations that are clear and logical to shareholders with respect to the allocation of management resources, such as reviewing their business portfolio and investments in fixed assets, R&D, and human capital, and specific measures that will be taken in order to achieve their plans and targets.

Supplementary Principle

5.2.1 In formulating and announcing business strategies, etc., companies should clearly present the basic policy regarding the business portfolio decided by the board and the status of the review of such portfolio.

Code of stewardship

Limitations

There are some limitations to the Japanese Stewardship when compared to the English code. Japan created a reporting system in 2006 in order to prevent activists. However, since the Stewardship Code was implemented in 2014, the reporting system no longer deters activists much at all. Instead, they simply burden large mainstream institutional investors, especially passive funds, and hinder them from acting as better stewards.

Principle 1: Institutional investors should have a clear policy on how they fulfil their stewardship responsibilities, and publicly disclose it.

Guidance

1-1. Institutional investors should aim to enhance the medium- to long-term return on investments for their clients and beneficiaries by improving and fostering investee companies' corporate value and sustainable growth through constructive engagement, or purposeful dialogue⁵, based on in-depth knowledge of the companies and their business environment and consideration of sustainability (medium- to long-term sustainability including ESG factors⁶)⁷ consistent with their investment management strategies.

1-2. Institutional investors should have a clear policy on how they fulfil their stewardship responsibilities (hereafter, "stewardship policy") and publicly disclose it. The stewardship policy should cover how they define the responsibility and how they fulfil it, in view of their role in the investment chain running from their clients and beneficiaries to the investee companies. Institutional investors should clearly specify how they take the issues of sustainability into consideration in their policy, consistent with their investment management strategies.

1-3. Asset owners, in line with their size and capabilities, etc., should encourage asset managers to engage in effective stewardship activities to secure beneficial owners' interests while taking their viewpoints into consideration. When asset owners directly manage funds and exercise their voting rights, in line with their size and capabilities, etc., they should engage in stewardship activities, such as holding dialogues with investee companies.

1-4. When selecting or issuing mandates to asset managers, asset owners, in line with their size and capabilities, etc., should clearly specify issues and principles to be required in conducting stewardship activities including the exercise of voting rights, in order to ensure

effective stewardship activities. In particular, large asset owners should proactively consider and clearly specify issues and principles to be required in conducting stewardship activities, including the exercise of voting rights, keeping in mind their positions and roles in the investment chain, instead of mechanically accepting asset managers' policies without any verification.

1-5. Asset owners, in line with their size and capabilities, etc., should monitor whether their asset managers conduct stewardship activities in line with asset owners' policies, for example, making use of asset managers' self-evaluations. In conducting such monitoring, asset owners should put emphasis on the "quality" of stewardship activities such as dialogue between asset managers and investee companies, etc., instead of mechanically checking the number of meetings held between them, the duration of such meetings and the "for" or "against" ratio of proxy voting, etc.

Principle 2: Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.

Guidance

2-1. While institutional investors should put the interest of their client and beneficiary first in conducting stewardship activities, they inevitably face the issue of conflicts of interest from time to time, for example when voting on matters affecting both the business group the institutional investor belongs to and a client or beneficiary. It is important for institutional investors to appropriately manage such conflicts.

2-2. Institutional investors should put in place and publicly disclose a clear policy on how they effectively manage key categories of possible conflicts of interest. In particular, asset managers should identify specific circumstances that may give rise to conflicts of interest which may significantly influence the exercise of voting rights and/or dialogue with companies and set out and disclose specific policies on measures for effectively eliminating the influence of such conflicts including avoiding such conflicts, thus securing the interests of clients and beneficiaries.

2-3. Asset managers should establish and disclose governance structures, such as an independent board of directors or third party committees for decision-making or oversight of voting, in order to secure the interests of clients and beneficiaries and prevent conflicts of interest.

2-4. The management of asset managers should recognize that they themselves have important roles and responsibilities in strengthening the governance of asset managers and managing conflicts of interest and should take action on such issues.

Principle 3: Institutional investors should monitor investee companies so that they can appropriately fulfil their stewardship responsibilities with an orientation towards the sustainable growth of the companies

Guidance

3-1. Institutional investors should appropriately monitor investee companies so that institutional investors can fulfil their stewardship responsibility with the aim of enhancing the medium- to long-term corporate value and capital efficiency and supporting the sustainable growth of the companies.

3-2. Institutional investors should monitor investee companies continuously and review as appropriate the effectiveness of the monitoring.

3-3. When investors monitor investee companies, a variety of factors, including non-financial ones, may be considered as relevant. Factors may include, for example, the investee companies' governance, strategy, performance, capital structure, business risks and opportunities (including risks and opportunities arising from social and environmental matters), and how the companies address them. Relevance of a factor may depend on each investor's investment management strategy and may differ according to specific investee companies. Institutional investors need to use their own judgment in choosing which factors to focus on in light of their stewardship responsibilities. They should endeavour to identify at an early stage issues that may result in a material loss in the value of investee companies.

Principle 4: Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.

Guidance

4-1. Institutional investors should endeavour to arrive at an understanding in common, with investee companies through constructive dialogue, with the aim of enhancing the companies' medium- to long-term value and capital efficiency and promoting their sustainable growth. In case a risk of possible loss in corporate value is identified through the monitoring of and dialogue with companies, institutional investors should endeavour to arrive at a more in-

depth common understanding by requesting further explanation from the companies and to solve the problem.

4-2. When they engage in the issues of sustainability, institutional investors, should consciously engage in dialogue that is consistent with their investment management strategies and that leads to the medium- to long-term increase of corporate value and the sustainable growth of companies.

4-3. Because passive management provides limited options to sell investee companies' shares and needs to promote their medium- to long-term increase of corporate value, institutional investors should actively take charge of engagement and voting from a medium- to long term perspective.

4-4. Institutional investors should have a clear policy in advance on how they design dialogue with investee companies in various possible situations.

4-5. In addition to institutional investors engaging with investee companies independently, it would be beneficial for them to engage with investee companies in collaboration with other institutional investors (collaborative engagement) as necessary.

4-6. In principle, institutional investors can well have constructive dialogue with investee companies based on public information, without receiving information on undisclosed material facts. The "G20/OECD Principles of Corporate Governance" and the Tokyo Stock Exchange's "Japan's Corporate Governance Code" set the principle of the equitable treatment of shareholders, which applies to the handling of undisclosed material facts. Institutional investors that have dialogue with investee companies should be aware that the companies are expected to abide by the principle and should in essence be discreet in receiving information on undisclosed material facts

Principle 5: Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist: it should be designed to contribute to sustainable growth of investee companies

Guidance

5-1. Institutional investors should seek to vote on all shares held. They should decide on the vote in light of the results of the monitoring of investee companies and dialogue with them.

5-2. Institutional investors should have a clear policy on voting and publicly disclose it. Institutional investors should try to articulate the policy as much as possible. The policy should not be comprised only of a mechanical checklist: it should be designed to contribute to sustainable growth of the investee company.

5-3. Institutional investors should at a minimum aggregate the voting records into each major kind of proposal, and publicly disclose them. Furthermore, to enhance visibility of the consistency of their voting activities with their stewardship policy, institutional investors should disclose voting records for each investee company on an individual agenda item basis. If there is a reason to believe it inappropriate to disclose such company-specific voting records on an individual agenda item basis due to the specific circumstances of an investor, the investor should proactively explain the reason. At the time of their voting records disclosures, it is also considered beneficial in enhancing visibility for institutional investors, to explicitly explain the reasons why they voted “for” or “against” an agenda item. In particular, institutional investors should disclose their voting rationale with respect to either “for” or “against” vote, which are considered important from the standpoint of constructive dialogue with the investee companies, including those perceived to have conflicts of interest or those which need explanation in light of the investors’ voting policy

5-4. When institutional investors use the service of proxy advisors, it is important that they use the service based on an understanding of the voting recommendation process, including the human and operational resources of the advisors. They should not mechanically depend on the advisors’ recommendations but should exercise their voting rights at their own responsibility and judgment based on the results of the monitoring of the investee companies and dialogue with them. When disclosing their voting activities, institutional investors using the service of proxy advisors should publicly disclose the name of the advisor and how they utilize the service in making voting judgments specifically.

Principle 6: Institutional investors in principle should report periodically on how they fulfil their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries

Guidance

6-1. Asset managers should in principle report periodically to their direct clients on how they fulfil their stewardship responsibilities through their stewardship activities.

6-2. Asset owners should in principle report at least once a year to their beneficiaries on their stewardship policy and on how the policy is implemented.

6-3. When reporting to their clients and beneficiaries, institutional investors should choose the format and the content of the reports in light of any relevant agreement with the recipients and the recipients’ convenience, and the costs associated with the reporting, and should aim to deliver effective and efficient reports.

6-4. Institutional investors should maintain a clear record of their stewardship activities, including voting activities, to the extent necessary to fulfil their stewardship responsibilities.

Principle 7: To contribute positively to the sustainable growth of investee companies, institutional investors should develop skills and resources needed to appropriately engage with the companies and to make proper judgments in fulfilling their stewardship activities based on in-depth knowledge of the investee companies and their business environment and consideration of sustainability consistent with their investment management strategies.

Guidance

7-1. To make dialogue with investee companies constructive and beneficial, and to contribute to the sustainable growth of the companies, institutional investors should develop skills and resources needed to appropriately engage with the companies and to make proper judgments in fulfilling their stewardship activities based on in-depth knowledge of the companies and their business environment and consideration of sustainability consistent with their investment management strategies. Institutional investors should have the necessary internal structure to have appropriate engagements and make proper judgments.

7-2. In particular, the management of institutional investors should have appropriate capability and experience to effectively fulfill their stewardship responsibilities, and should be constituted independently and without bias, in particular from their affiliated financial groups. The management of institutional investors should also recognize that they themselves have important roles and responsibilities to carry out stewardship activities such as enhancing dialogue, structure their organizations and develop human resources, and take action on these issues.

7-3. Exchanging views with other investors and having a forum for the purpose may help institutional investors conduct better engagement with investee companies and make better judgments.

7-4. Institutional investors should endeavour to improve their policies based on the Code and the quality of their stewardship activities by reviewing at an appropriate timing the status of their implementation of each principle, including guidance. In particular, asset managers should regularly conduct self-evaluations with respect to the status of their implementation of each principle, including guidance, disclose the results toward continued improvement of their governance structures, conflicts of interest management, and stewardship activities, etc., and disclose such results together with the results of their stewardship activities including dialogue with companies. In doing so, asset managers should be conscious that these are

consistent with their investment management strategies and lead to the medium- to long-term increase of corporate value and the sustainable growth of companies.

Principle 8: Service providers for institutional investors should endeavour to contribute to the enhancement of the functions of the entire investment chain by appropriately providing services for institutional investors to fulfil their stewardship responsibilities

Guidance

8-1. Service providers for institutional investors including proxy advisors and investment consultants for pensions should identify specific circumstances that may give rise to conflicts of interest, put in place a clear policy how to manage them effectively, develop structures for conflicts of interest management, and disclose such measures.

8-2. Proxy advisors should develop appropriate and sufficient human and operational resources, including setting up a business establishment in Japan in order to provide asset managers with proxy recommendations based on accurate information on specific companies. They should also disclose with specificity the voting recommendation process, including the above measures to assure transparency.

8-3. In providing proxy recommendations, proxy advisors should rely upon corporate disclosure, and actively exchange views with companies upon necessity. Upon the request from a company that is the subject of a proxy recommendation, it is considered to contribute to secure accuracy of the information that is the basis for the recommendation and transparency that the proxy advisors provide the company with an opportunity to confirm whether such information is accurate, etc., and provide the submitted opinion of the company to their clients together with the recommendation.

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