



Corporate Governance Reform: Enhancing Japan's Power to EARN "Japan to maintain itself as Asia's Alpha"

Upcoming Possible Code Reforms

For 2018:

- Mandating outside directors
 - Setting a percentage of outside directors in the code rather than a fixed number of outside directors
- Requirement of diversity in board members
 - More women on the board as well as foreigners
- Clear qualification of CEO appointment and dismissal
 - Setting up an independent nomination committee

For the future:

- Transparency in appointing outside directors
- Clear training curriculum for directors and CEOs
- Transparency of capital allocation

Background

The implementation of the Corporate Governance Code ("CG Code") in Japan has been a central pillar of the Abe administration's Japan Revitalization Strategy. The strategy, which was approved by the Cabinet in 2013, has the stated sole purpose of increasing the sustainable growth and medium-to-long-term corporate value of Japanese companies. The driving principle of the GC code is "growth-orientated governance," and since its introduction measures to strengthen the policy have been introduced in rapid succession.

The CG Code forms part of the third arrow of Prime Minister Abe's so-called "Abenomics," policies designed to re-ignite the Japanese economy. This third arrow, focused on structural reforms, is targeting transparent, equal and decisive decision making by companies, while also considering the interests of shareholders and being more open to other stakeholder's perspectives. This means making businesses more responsive to their customers, employees and local community groups and associations.

This represents a clear break with previous approaches to corporate governance in Japan, which has never had a strong corporate governance structure. GMI Ratings 2010, the leading provider of global corporate governance and ESG ratings, ranked 28 countries by the quality of their corporate governance. Japan clocked-in at an abysmal 26th, below Brazil, South Africa, Russia and China. It wasn't until 2010 that the idea of corporate governance reform was even mentioned in Japan. Describing the overhaul of corporate governance as "revitalization" obscures the fact that Japan was effectively starting from scratch.

In 2014, in a league table titled the "Clarity and Completeness of Corporate Governance Requirements" conducted by ACCA and KPMG, Japan was ranked 21st out of 25 countries, below regional rivals such as the Philippines, Indonesia, Thailand and South Korea. From this point on the tide began to turn. The GC code, which was now a year old, was beginning to work its way into the mindset corporate of Japan and be recognized as essential to Japan's future success.

By 2017 the situation had improved. The 2017 World Corporate Governance Index grouped Japan in the top tier for corporate governance along with 19 other countries such as Australia, the United States and the United Kingdom.

Today it can be said that the implementation of the policy has been a success - after only four years Japan has been able to significantly boost its rankings in corporate governance.

Despite this success in the rankings, it is unclear how fully implemented the policy has been within Japanese companies. There are still a number of unanswered questions: have Japanese listed companies complied with the new code? Has the Japanese market achieved the desired level of transparency and information disclosure? Has share value maximization been fully adopted by corporate management in Japan? These questions cannot truthfully be answered affirmatively. An honest answer would be "not yet, but we're getting there." Historically, Japan reacts slowly to reforms - accepting some change but displaying a reluctance to fully commit to a radical shift in thinking. This tendency can be traced back to the Meiji Restoration and the slow but steady dispersion of Western values and ideas into Japanese society. The implementation of the GC code is no different and full compliance and implementation can be expected to take around a decade.

The True Purpose of the CG Code

Critics say that Japan only started to implement the GC code to move itself above developing countries in governance league tables. The implication being that the policy is about pride and stature, but does not effectively support the only true measure of success: economic growth. During the 2015 Kyoto Bank New Year gala, the Keidanren, the Japanese business federation, mentioned that Japan is the only major and developed country with an economy that does not grow.

The comments were made with one eye clearly on China. The purpose of the GC code is not only to improve its corporate governance amongst its peers and keep ahead of emerging economies, there are larger geopolitical reasons focused on the emergence of a powerful China.

Up until 2011, Japan was the largest economy in Asia and the second largest economy in the world. In pure economic might China has now overtaken Japan and is a still a growing and rising power.

Statistics show that China's economy expanded at an annual rate of 6.9% in the second quarter of 2017, surpassing the government's initial targets. Since Japan's bubble economy collapsed in the early 1990s, Japan has been experiencing stagnation and deflation along with devastating natural disasters, such as the 2011 earthquake and tsunami. Annual GDP growth rate has averaged a paltry 2.02 per year from 1981 to 2017. In recent years China has been growing at least three times as fast as Japan.

Although Japan has been a stronghold for technological innovation for many decades, China has been catching up quickly. While some predict that within half a century Japan will regain its position as the strongest economy in Asia, this is due not to strong Japanese growth but the risk of a Chinese economic collapse. Practically, despite Abe's efforts and strategy to revive the Japanese economy, it is unimaginable that Japan will regain the title of Asia's alpha without drastic reforms that boost Japan's ability to earn and to grow.

Code Implementation and effect

Boosting Japan's growth potential depends on the extent to which the CG code is adopted. The CG code is applicable to all listed companies on the first and second sections of the Tokyo Stock Exchange. The current CG code was implemented in June 2015 and every company was given a choice; comply with the GC code or explain why you can't. Most of the companies that have not complied fully with the GC code are powerful domestic multinationals that have been around for a long time and have what could be described as a traditional approach to business.

Despite some institutional resistance within the business community, certain aspects of the code have been successfully implemented. One aspect relates to the composition and responsibility of a company's board of directors. The current code states that "the company should appoint at least two independent directors who have relevant qualities." By July 2014, around 65% of TSE-listed companies had external directors, and by July 2015 that number had increased to 90%. In December 2015, all Nikkei 225-listed companies had at least one external director on their boards.

With other codes, such as creating a nomination committee for the CEO, most companies have complied. A small number of late adopters are still 'explaining' why they have not yet reformed themselves, but it can be expected that with time these GC code practices will become universal.

Overall, it does appear that most Japanese companies are complying with the GC code. The real question lies in whether these corporate governance reforms will increase Japan's power to earn.

Changes to be made in 2018

The GC Code is subject to amendment and in 2018 the Nikkei Shimbun, a major Japanese newspaper that covers general business news, reported the following three changes were being considered: a requirement for one third of a company's directors to be external appointments; greater transparency in the appointment and dismissal of CEOs; and a requirement for all companies to have at least one female director.

Mandating external directors

Although it is currently unclear what the percentage of external directors will be, the previous total number of two was deemed insufficient by corporate governance experts in some cases. Depending on the size of the company, the number of directors on the board will range from 5 people to around 20 people. The code will vary depending on the size of the board. There is currently a debate about whether the number of external directors should be a total percentage rather than a simple number.

The aim of having more external directors is to better represent the interests of all shareholders, to give a voice to third parties and have directors who can operate without undue influence from senior management.

Blackpeak interviewed Japanese directors in the automobile, service and insurance companies, who acknowledged the need for external directors but caveated the point by saying that whether the external director can in practice operate independently is another question.

In interviews with Blackpeak, foreign directors in Japanese insurance companies were unanimous in arguing that Japanese boards need to be more diverse, highlighting a lack of foreign board members and women more generally. In a world of rapid globalization, Japanese companies are waking up to the fact they must become more internationalized and diverse. Diversity means not just a number of external directors, but specifically female directors and directors from other cultures. More global perspectives, they argued, would help Japanese companies navigate a shifting international business environment.

In Japan, it has widely been accepted that despite Japan's great success as an exporting nation it lacks an international perspective at a human resources level. This factor is significantly weakening Japan's competitiveness and prospects for greater growth.

Requirement of more diverse board members

Practically speaking, diversity means newly appointed board members should be female, foreign or both. More than half of the companies in the TOPIX500 do not have female directors, and almost none of the TOPIX500 companies have foreign directors.

A lack of diversity in the boardroom can lead to poor decision making and can foster a negative attitude towards governance reform. A positive sign was that the Japanese directors we interviewed were passionate about the need for diversity in the boardroom.

For the directors, one of the benefits of a more diverse board is the greater range of perspectives it allows. This increases depth of institutional knowledge and facilitates more effective corporate governance, allowing the group to better anticipate problems and better address the interests of all stakeholders—shareholders, customers and employees.

New requirements will present new challenges, not least the question of how much trust and critical company information will be provided to external directors compared to internal ones. As it stands, there are no specific criteria for hiring external directors in the GC code, and external directors are defined as any directors who are not employees of the firm. It is difficult to measure precisely how independent an external director is upon appointment, as the previous relationship between an external director and the company does not need to be clarified when making the appointment.

Despite the potential issues this approach raises, the Japanese directors who spoke to Blackpeak were enthusiastic about this "hot topic," and were supportive of efforts to increase diversity at a boardroom level.

Clear qualification of CEO appointment and dismissal

It is well known that in Japan that CEOs of Japanese companies are either people who have served the company the longest or are part of the founding family. In Japan, loyalty is prized and rewarded.

There are few examples of companies truly considering the qualities required for the CEO and subsequently appointing someone outside the company to the position.

In fact, the metrics used to consider CEO appointments are unclear across corporate Japan. It is not unusual for newly appointed CEOs to say during an interview or a press conference that they were “very surprised to be given this position.”

Investors have a right to know why a particular person was chosen and what particular qualities they have that will ensure the future growth and investment of the company. A future reform of the GC code will include more explicit and clearer succession planning.

The current code states that a company must use a nomination committee to appoint the next CEO. The success of the committee depends on whether it is made up of insiders who have less maneuverability to act independently or external directors who are better able to hold dissenting viewpoints and put across challenging opinions.

Future Changes beyond 2018

The changes that are taking place this year are only the beginning of the reform process. As mentioned, Japan typically takes its time when adapting to change, and bringing business practices in line with the GC code will be no different. Yet even if it happens slowly, it will happen. Japanese business culture is such that once one company starts 90% will follow. There may be resistance to the reforms, but true opposition is unlikely.

The GC code is not final. It will continue to be amended well beyond the June 2018 deadline for new changes. The Code intertwines with the Stewardship Code, which is renewed every 2 years. It is likely that the CG code will also follow this timeline.

Further areas of reform will be announced in June of this year. This will include transparency when appointing external directors, clarity with regards to the qualities required for external directors, a process for CEO appointments that is clear and merit-based, and a standardized and clear curriculum for director and CEO training.

Transparency in appointing external directors

Almost all listed companies in Japan now have appointed at least one external director to their board. The central question is on what basis are they being appointed, and whether the external directors are able, or have the inclination, to act independently.

In some cases, the external directors have no prior knowledge of the industry, making it is hard to measure the value they can add to the company. There are other cases where a newly appointed external director is not independent. Finally, there are cases where the individual holds shares in other companies in the same group, effectively preventing them from operating as an independent outsider.

It will be important for companies to create a hiring standard for incoming external directors and make the process public.

Clear curriculum of Director and CEO training

At present, there is no special training for directors. When training requirements were suggested, opponents argued that people placed on a board should already have enough knowledge for the role, and that companies that had never needed to train board members previously should not have to start now.

The Japanese government disagreed, and in 2009 established an organization to raise the standard of directors and CEOs. This organization was a non-profit “public interest” organization consisting of experts and opinion leaders called the Board Director Training Institute of Japan (BDTI). Accurate statistics are difficult to cite, but since 2009, many people who were appointed to a Japanese boardroom have attended at least one of BDTI’s training programs.

It is rumored that the CG code will include language requiring newly appointed directors, both internal and external to the company, to attend the BDTI or a similar institution, follow a clear curriculum and provide progress reports on their training.

Transparency of Capital Allocation

A further area that will be addressed in 2018 relates to capital allocation. In Japan, it is often the case that outside investors do not always fully understand the criteria being used to determine how the capital of

a Japanese firm is being invested. In the current code, capital allocation is discussed in the shareholder section.

At present, there is little guidance other than that companies should disclose their investment targets and capital efficiency policies and provide logical explanations for their decisions. According to a leading expert in corporate governance, there are proposals to include a requirement that a company must provide a statement that explains why a certain amount of capital is being invested and whether that capital is related to research and development or human capital investment.

Policies surrounding the transparency of capital allocation vary depending on the company, the industry and the business cycle. Collectively this makes it difficult for the code to provide clear uniform guidance. Despite this difficulty, the existing code could be more specific in its guidelines. At a minimum, the code should be more strongly worded.

CLARITY and TRANSPARENCY

The three areas discussed suggest that future reform of the CG code will focus on clarity and transparency within a company structure. In this way, the GC code targets what has been a major challenge for Japanese companies. Typically, in Japanese business culture there is a preference to manage business policy and decisions internally. The GC code aims to open up Japanese companies to ensure that they are providing proper disclosure regarding appointments.

An expert who spoke to Blackpeak stated that company disclosure should go beyond the basic information that is required by the letter of the law. The proposals still leave the situation very vague, and in practice it would be difficult to brand a company's disclosure as insufficient unless it were egregiously and obviously inadequate when compared to other similar companies.

Shareholders make decisions based on the information that companies disclose. It is difficult to understate the importance of revealing information to shareholders, particularly as activist shareholders are increasingly making their voices heard in the Japanese market. The new code is generally friendly and supportive of this activism, and engagement by shareholders is encouraged.

An executive director of a major Japanese insurance company stated that there is only one point to keep in mind from a shareholder's point of view when it comes

to transparency of information: can you trust the information that is disclosed? A Section of the current CG code states that companies should be more transparent, but it is important to bear in mind that companies are being forced to reveal information that they normally would want to keep to themselves.

This tension will remain after the reforms have been pushed through. Even when corporate disclosure is more comprehensive, shareholders will still need to verify information rather than automatically take it at face value.

Final Remarks

The Liberal Democratic Party, led by the Abe administration, has been spurred by geopolitical considerations to implement corporate governance reform. The purpose of the reform is to boost Japan's ability to grow. While tremendous progress has been made, there is significant work that must be achieved in the next few years if Japan is to regain its position as the alpha economy in Asia.

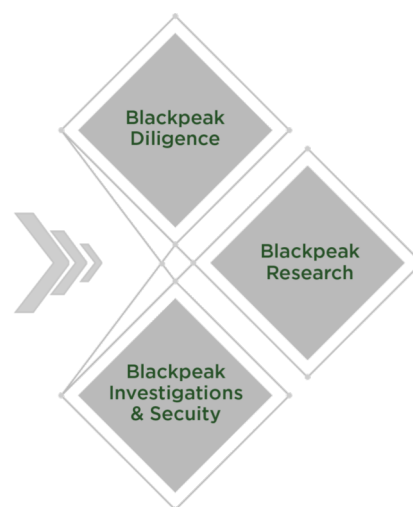
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