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Moving beyond appointment of nonexecutive directors to board performance evaluation

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Executive Summary

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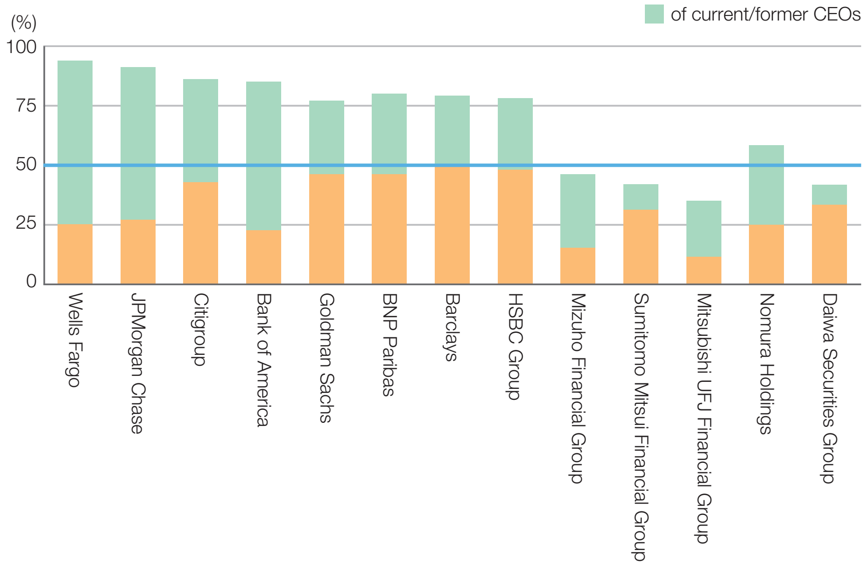
Japanese financial institutions have started to work on upgrading their corporate governance through such means as appointing multiple nonexecutive directors in response to government-led legal reforms. G-SIFIs have boards predominantly comprised of nonexecutive directors and are already moving on to board performance evaluations.

Board composition at major Japanese financial institutions versus Western G-SIFIs

The Japanese government has been promoting enhancement of "growth-oriented" corporate governance that boosts Japanese companies' earnings power as one component of its Japan Revitalization Strategy. In the same vein, it has amended the Companies Act and unveiled a Stewardship Code and Corporate Governance Code in the aim of nudging Japanese companies to appoint multiple nonexecutive directors and improve their ROE. US proxy advisory firms influential with institutional investors are likewise pressuring Japanese listed companies to appoint nonexecutive directors

Exhibit 1. Percentage of board seats occupied by independent nonexecutive directors at major financial institutions (as of August 31, 2015)



Note: Data for Barclays are current as of June 30, 2015.
Source: NRI, based on above companies' public disclosures

at their shareholder general meetings. Against such a backdrop, Japanese financial institutions are upgrading their governance, though they lag behind major European and US G-SIFIs (global systemically important financial institutions) in this regard.

At nearly all major European and US G-SIFIs, independent nonexecutive directors occupy over 80% of board seats (Exhibit 1). The G-SIFIs have separated executive and oversight functions by appointing majority-independent boards of directors and, beneath those boards, majority-independent nominating, compensation and audit committees to exercise oversight of management. Additionally, the G-SIFIs' nonexecutive directors are mostly current or former corporate executives, including a high percentage of CEOs[1], instead of the balanced mix of attorneys, accountants and corporate executives that is typical in Japan.

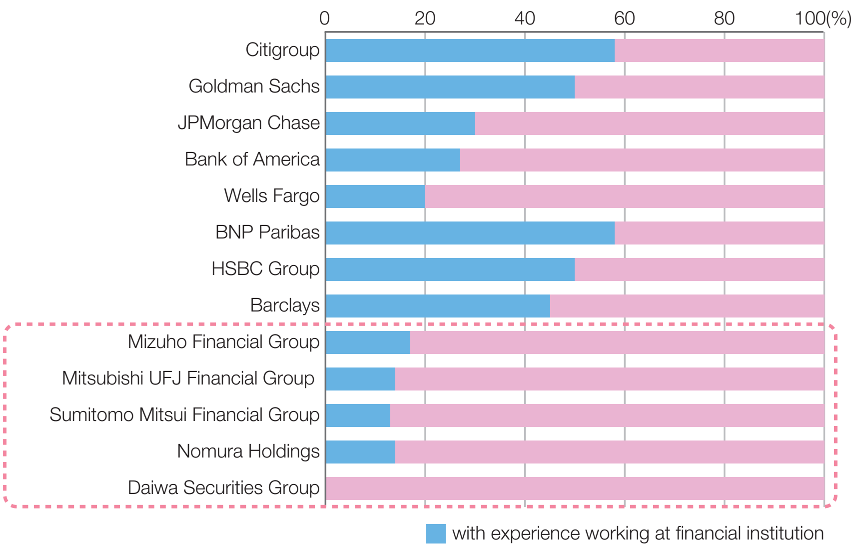
Moreover, the foreign G-SIFIs appoint nonexecutive directors with in-depth financial knowledge. Current or former financial institution executives[2] account for more than half of the nonexecutive directors at G-SIFIs such as BNP Paribas, HSBC and Goldman Sachs (Exhibit 2). Recruitment of nonexecutive directors with industry-specific expertise is not limited to the financial sector. At Google and BP, for example, most nonexecutive directors are IT and energy industry executives, respectively. Many European and US G-SIFIs have appointed former CFOs as nonexecutive directors, implying that they value expertise in corporate financial strategy. European G-SIFIs

NOTE

1) CEO here means corporate CEOs, excluding CEOs of small businesses.

2) Defined as individuals with at least five years of experience working at a financial institution.

Exhibit 2. Percentage of independent nonexecutive directors with experience working at a financial institution (as of August 31, 2015)



Source: NRI, based on above companies' public disclosures place priority on diversity also, with women and/or foreign nationals accounting for a high percentage of directors[3].

In Japan, by contrast, most major financial institutions have more inside directors than nonexecutive directors on their boards. Current and former CEOs account for a high percentage of nonexecutive officers (directors and corporate auditors[4]) at major Japanese financial institutions, like at foreign G-SIFIs. At Japanese regional banks, however, nonexecutive directors tend to be mostly attorneys and accountants. Whether a board comprised mainly of individuals without corporate management experience is an appropriate arbiter of corporate management fundamentals such as business strategy and medium-term planning is subject to debate. Many regional banks have no nonexecutive directors with experience working at a financial institution, albeit largely due to a limited pool of available candidates, reflecting Japan's lack of labor market fluidity.

Board performance evaluations under Corporate Governance Code

Major European and US G-SIFIs have already moved beyond discussing their boards' outward composition and are now focusing on how well their boards, board committees and individual directors are actually functioning. They annually evaluate their boards, focusing mainly on nonexecutive directors, and disclose the evaluation results in their annual reports. Additionally, the UK and France's corporate governance codes require that listed companies' boards be objectively evaluated triennially by an external body[5]. HSBC and BNP Paribas have their boards evaluated by Bvalco, an independent board review firm, and publish the evaluation results in their annual reports (Exhibit 3)[6].

Board evaluation guidelines published by the UK's Financial Reporting Council[7] (FRC) are used as a reference for conducting board evaluations. Specific points that the FRC recommends evaluating include "the mix of skills, experience, knowledge and diversity on the board in the context of the challenges facing the company," "succession and development plans," "effectiveness of Board committees and how they are connected with the main board" and the "quality of discussions around individual proposals."

Japan's Corporate Governance Code likewise recommends that companies' boards conduct annual self-evaluations. Kao published the results of such an evaluation in its August 2015 Report Concerning Corporate Governance. Specific points covered by Kao's evaluation included discussion of the company's broad direction (e.g.,

3) Women occupy 39% of board seats at HSBC and 47% at BNP Paribas, a French company; foreign (i.e. non-French) nationals occupy 33% of board seats at BNP Paribas (as of August 31, 2015, per the companies' websites).

4) Sumitomo Mitsui Financial Group (SMFG) has a board of corporate auditors in addition to a board of directors and is therefore not perfectly comparable with other major Japanese financial institutions. In SMFG's case, the percentages in Exhibits 1 and 2 were calculated based on total corporate officers inclusive of both directors and internal and nonexecutive auditors.

5) In the UK, this requirement applies only to FTSE 350-constituent companies (the top 350 London Stock Exchange-listed companies ranked by market capitalization).

6) Additionally, they disclose the results of performance evaluations of their nominating, compensation and audit committees and individual directors.

7) The FRC advises and supervises accounting standard setters and formulates and oversees a corporate governance code.

Exhibit 3. Excerpts from external evaluation of HSBC's Board of Directors (2013)

Points evaluated	Evaluation
Appropriate balance of board meeting agenda items (e.g., regulatory matters, business matters, strategy)	Important matters were discussed on a priority basis. More time was devoted to important matters than to less important matters.
Opportunities, other than board meetings, for discussion of issues between nonexecutive directors and executive directors	Nonexecutive directors met informally with executive directors before and/or after board meetings. Nonexecutive directors were invited to many meetings attended by executive directors. When visiting HSBC local offices, nonexecutive directors met with local senior management.
Scheduling of nonexecutive director meetings	Meetings exclusively for nonexecutive directors were held before and/or after board meetings.
Succession planning	The board conducted succession planning on an ongoing basis as part of its formal governance processes. Individuals named in succession plans gave presentations at board meetings.

Source: NRI, based on HSBC Group's 2013 annual report

corporate strategy), establishment of an environment supportive of appropriate risk-taking by senior management, effective oversight of directors and management from an independent, objective standpoint, and constructive communication with shareholders and investors. Aside from Kao, however, hardly any other Japanese companies have conducted such evaluations. In the financial sector, no company to date has specifically disclosed the results of a board performance evaluation. Going forward, investors also will likely pressure companies to start conducting board performance evaluations.

The quality of board discussions presumably differs considerably between Japanese financial institutions that have just started to appoint multiple nonexecutive directors and major European and US G-SIFIs with majority-independent boards comprised largely of CEOs as discussed above. With the stage now set for Japanese companies to start evaluating how well their boards function, Japanese financial institutions' boards are poised to play a much more active role in vetting medium-term management plans and business strategies.

about NRI

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