NRI

lakyara vol.228

Special Edition

Governance reforms aim to boost corporate earning power

- Interview with Kazuhiro Takei by Sadakazu Osaki -

10.December.2015

Nomura Research Institute, Ltd.

Executive Summary

There has been a great deal of progress in corporate governance reforms in Japan aimed at boosting companies' earning power, including revisions to the Corporation Law and the adoption of stewardship and corporate governance codes. How do we boost earning power with governance reforms? To help us answer that question, we spoke with Kazuhiro Takei, a leader in the debate on governance reforms in Japan.

Kazuhiro Takei

Partner, Nishimura & Asahi

Admitted to Japanese bar in 1991. Graduated Harvard Law School (LL.M.) in 1996, University of Oxford (MBA) in 1997. Handles general corporate law and M&A for listed companies. Member of FSA's Council of Experts Concerning the Corporate Governance Code and METI's Study Group for Promoting Dialogue Between Companies and Investors. Author of numerous books including A Practical Introduction to Corporate Governance Code (Nikkei BP, 2015).

Sadakazu Osaki

Head of Research, Center for Strategic Management and Innovation, NRI

Joined Nomura Research Institute in 1986. Graduated University College London (LL.M.) in 1990. Appointed director of Capital Markets Research Department in 1999. Appointed Head of Research in Center for Strategic Management and Innovation in April 2008. Currently a visiting professor at Waseda University and the University of Tokyo. Member of Financial System Council and Council for Regulatory Reform. His many books include Seminar on Financial Instruments and Exchange Law (2013; jointly authored with Zenichi Shishido).

How can we boost earning power with governance reforms?

Osaki: The corporate governance reforms being implemented by the government often emphasize the enhancement of earning power. I have a very different impression of corporate governance, inasmuch as governance reforms in the US and UK have historically focused on preventing scandals.

Takei: People define governance in a variety of ways. In the legal world the need to clarify legal responsibility leads many to discuss it in terms of preventing malfeasance. In other countries, however, the standard practice is to distinguish between the concepts of compliance and governance. Compliance refers to the question of what a company should do within the regulatory framework laid down by the authorities, while governance tends to be used in the sense of coordinating the interests of various stakeholders to enable the sustainable growth of the company. In other words, longer-term corporate growth has a necessary condition of avoiding negative outcomes via compliance, but it also has a sufficient condition of developing the positive, with governance serving as the framework that enables both to be achieved sustainably.

Osaki: I find very interesting your comment that the central role of governance is to coordinate the interests of various stakeholders. While discussions of governance in Japan often tend to emphasize the interests of shareholders, it is more than just that.

Takei: An increase in business value will naturally benefit shareholders, but it is difficult for shareholders to increase business value through their own efforts. That can only be accomplished by management. Although shareholders are also important stakeholders, I believe business value can grow only if the interests of all stakeholders are taken into account.

Osaki: Is it really possible to enhance earning power with governance reforms?

Takei: Japanese businesses need to accept a diverse range of values and stakeholders in order to grow. By doing so I believe they can enhance their earning power.

With today's rapidly changing business environment, it is critical that Japanese companies respond appropriately to globalization and advances in IT. In terms of globalization, the question is how to bring in people who speak different languages and who hold different values to serve as drivers of future growth. In order to attract highly qualified local executives to an overseas subsidiary that has been created or acquired, for example, Japanese companies need to compete with local firms based on the assumption that the competition will be world-class. Emerging victorious requires a deep understanding of local values.

The current corporate governance code contains a number of elements designed to determine whether a company has a flexible organization that incorporates diverse values. In particular, Principle 2.4 discusses the need for a diverse management board to run the company, while Supplementary Principle 4.11.1 notes the need for a diverse board of directors (the supervisory board) to monitor executives. The question involves what sort of diversity the management board needs to exhibit and how the supervisory board can compensate for a lack of diversity in the management board, based on an understanding of the risk factors that need to be addressed if the company is to achieve longer-term growth.

Osaki: What I found particularly important in what you just said was that the government's governance code looks at diversity in both the supervisory board and the management board.

I think a common view in Japan is that the management board can consist entirely of people from inside the company as long as the supervisory board is a more diverse body that includes outside directors. But what you're saying is that management also needs to be diverse.

Takei: That's right. As businesses become increasingly globalized, people in local markets must be persuaded to choose Japanese (foreign) companies, and that requires a clear message from management. In Japan it is common for thoughts and opinions to be communicated implicitly, but that sort of approach will not work elsewhere. This is something Japanese companies must change if they hope to grow globally.

Merits of governance committee system

Osaki: Last year's revisions to the Corporation Act made it possible for companies to adopt a system of governance committees. Already 240 firms have migrated to this system or have indicated their intention of doing so. As one of the first to propose the introduction of this system, how do you think companies should make use of it?

Takei: I proposed the system of governance committees because I saw a need for deregulation in the Corporation Act.

Until this system was introduced, Japanese enterprises had to choose from one of two organizational structures: one with an audit committee, and one with a nominating committee.

The first took shape more than thirty years ago and required the board of directors to function as both a supervisory and a management board. Consequently, the board tended to get caught up in the day-to-day decision making required of a management board and had no time to discuss the company's direction or fulfill a supervisory role.

The nominating committee system was adopted ten years ago. While it made it possible for companies to create separate supervisory and management boards, there was a requirement that outside directors constitute a majority in each of the nominating, compensation, and audit committees. In my view, these two choices were far too restrictive. I proposed the governance committee system as a way to enable companies to set up separate supervisory and management boards, something that western companies can easily do.

Inasmuch as the governance committee system is a kind of deregulation, companies are responsible for designing an organizational structure that allows them to grow. To the extent that there are fewer restrictions, they must come up with an ideal structure that enables them both to develop the positive and avoid negative outcomes. It focuses attention on the company's true intentions as an organization. The essence of governance lies in this kind of "autonomous intent" to grow the company.

Osaki: Some have argued that the governance committee system makes it possible to reduce the number of outside directors (compared with an audit committee), since by appointing two outside directors a company can fulfill the requirements of both the governance code and legal requirements. But what you are saying is that organizational structure should not be approached from that perspective alone.

Takei: Whatever the motivation behind the organizational structure, ultimately the company itself must have the desire (autonomous intent) to implement governance. Some say there should be more extensive regulation of companies adopting the governance committee system, but that would only mark a return to the system of internal auditors that was common more than thirty years ago. Onerous laws and regulation will make it impossible for firms to respond flexibly to the rapidly changing global and external environment.

Changing role of AGMs

Osaki: Earlier you mentioned that the issue of how to address globalization and IT advances was becoming increasingly important. For example, there are now proposals to conduct annual shareholders' meetings electronically.

Takei: As globalization proceeds, I think it is only natural that we use the internet instead of the mails to handle AGM business. Greater adoption of IT is not just a question of the Corporation Act but also bears on the issue of how companies should deal with a more diverse group of individual shareholders, many of whom are senior citizens. The Corporation Act requires companies to communicate with shareholders via the mails, but I suspect changes will eventually be made with an eye on the extent of IT adoption among individual shareholders.

AGMs serve as a forum for companies to provide a variety of information to shareholders as well as allowing them to vote on company business. The former should be easy enough to implement electronically, but the latter will not be that simple, since it is essential to obtain an accurate vote count with no fraud. Voting in Diet elections, for example, is still conducted via paper ballots that are mailed out to voters.

Osaki: I have long wondered what purpose actual physical meetings will serve as AGMs become increasingly electronic. Why hold a physical meeting if everyone knows the agenda prior to the meeting and even the results of the votes may be largely known in advance?

Takei: In Japan there are still many investors who want to see the company president face-to-face at the AGM. Companies see the annual meeting as an event where, once a year, they have to respond to any and all questions and senior executives must take responsibility for their actions. I think this is a good thing. Since AGMs do provide this kind of discipline, I suspect many would object to a system where all votes on company resolutions were conducted online.

Osaki: This is something separate from the matter of whether votes have already been decided?

Takei: That's right. But to elaborate on your point, I think more of AGMs' role as a decision-making forum needs to be passed on to the supervisory board, taking into account the new governance code. Supervisory boards have yet to be adequately "visualized" in Japan. Hence there are currently only two places where decisions can be made: the AGM and the management board. In western countries, the supervisory board offers a third option.

Osaki: I see. So that is why investors are comfortable even when the role of the AGM has diminished somewhat.

Takei: I think the use of supervisory boards would enable the creation of a variety of new and efficient structures for the implementation of growth strategies, including more proactive ("offensive") forms of governance. Overseas companies that use supervisory boards do not have to make all their decisions at the AGM. Supervisory boards in the west are also charged with deciding director compensation.

Shareholders in listed companies have a variety of motives and can come and go as they please. Most capitalist countries have yet to answer the question of whether the exercise of voting rights by such a diverse group of shareholders under these conditions will actually lead to decisions that are in line with the company's longer-term growth strategy. Companies have many stakeholders other than the shareholders themselves, and they should make greater use of supervisory boards if they hope to create a trustworthy decision-making structure that persuades these stakeholders to maintain a longer-term relationship.

Osaki: From a different perspective, making a case to the supervisory board and winning its approval would give management the freedom to act as it felt best instead of fearing shareholders' exercise of their voting rights at the AGM or overreacting.

Takei: There is that, too. I think the current governance reforms will eventually enable some of the functions of the AGM to be shifted to the supervisory board. We will probably see more debate on the question of exactly what sorts of matters should be decided at the AGM.

Significance of presenting longer-term strategy to investors

Osaki: The issue in the future will be how companies move to implement these reforms.

Takei: I think it will be especially important that companies clearly explain to shareholders the strategies they deem necessary for longer-term growth. After all, there is no reason why a rational shareholder would want to hold the shares for the long run without such a strategy. Businesses should want their shares to be held by investors with a long-term perspective.

Most Japanese companies have a mission statement and medium-term business plans, but we seldom see 5- or 10-year strategies that can bridge the gap between the two. The claimed reason is that management have no way of knowing what conditions will be like in five or ten years, but unless they are able to come up with something it will be impossible for them to attract patient capital. There are some ways in which the Japanese business world remains a small town, with some firms operating on the assumption of lifetime employment and many holding a longer-term perspective, but I don't think that has been effectively communicated to outside investors.

Once it is, it will then be the responsibility of institutional investors to understand the situation. That is the original aim of the stewardship code. I think it is especially important that asset owners take a longer-term view of businesses. No matter how much asset managers may wish to take a longer-term view of a company, there is little they can do if asset owners panic at the announcement of each quarter's results.

Osaki: Also, investors seeking longer-term growth need to leave index investing behind. Simply being a TOPIX component does not guarantee longer-term growth for a company.

Takei: In that context, some are saying that we should make greater use of smart beta indexes like the JPX-Nikkei 400 or that we should increase our allocation to active managers. As was noted in the Ito report, if all investors simply pursue efficient management strategies and refuse to pay for stock selection, companies' efforts to explain their growth strategies to investors are likely to miss the mark.

Osaki: Companies are working very hard to implement the governance code since this is the first year. After a few years, frustrations may start to build at companies that feel investors aren't listening to them or don't have the knowledge required to understand what they are saying.

Takei: Companies and investors need to work together on this. To keep Japan from experiencing another "lost" 20 years, we need to create an environment that is friendly to risk capital.

Osaki: It looks as though improvements in governance will require long-term efforts on the part of both companies and investors. Thank you very much for joining us today.

about NRI

Nomura Research Institute, Ltd. ("NRI", TYO: 4307) is an independent, global IT solutions and consulting services provider with annual sales of 406.0 billion yen as of FY ended March 2015. With front-to-back support for the buy- and sell-side, NRI's tradition of innovation has positioned them as a trusted international market leader. Leveraging NRI's global consulting business, NRI is able to provide innovative financial IT solutions for investment banks, asset managers, banks and insurance providers. For more information, visit www.nri.com.

Inquiries to : Financial IT Marketing Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.com/global/opinion/lakyara/index