32nd Asian Shadow Financial Regulatory Committee Statement

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Board Governance in Japan: The Current State and Beyond

1. Current situation

Basic issues in corporate governance remain worrisome in both emerging and advanced Asian economies including Japan. The Japanese Corporate Governance Code took effect in June 2015 and has been amended recently including recommending raising the composition of independent directors to one-third. Although compliance is voluntary, support of both the Tokyo Stock Exchange and the regulators appears to have created a momentum exerting pressure on companies to comply.

Nearly 90% of all Tokyo stock exchange listed companies had independent outside directors by 2015. According to the 2016 Bain report, S&P500 outside directors hold an average of 84% of corporate board seats compared with only 23% for the Nikkei 225 listed companies in 2014. In addition, most US independent outside directors have executive management experience. The average S&P500 listed company has 6.5 independent outside directors with business experience against only 1.2 in Japan.

2. Review

Effective use of outside board members requires cultural change. In particular to bridge the gap between governance and execution. Japanese top management appear to fear the views and possible criticism of outsiders even though outsiders bring in new perspectives. At their best, they serve as a check and balance providing oversight of executive actions and offering objective, unbiased critique. It is important for Japanese corporations to develop a proper governance mindset to effectively close the gap between governance and execution. Companies should seek out independent points of view from outside directors to provide oversight and advice on strategy. In addition, independent outside directors should work towards owning the processes of CEO appointment succession, compensation and performance review. Japanese corporations face many challenges in shifting to this ideal management structure, including overcoming the traditional employee-driven nature of many Japanese companies. The evolution will not be easy and takes time. Many companies will face internal biases and suspicions on the views of independent outside directors. Furthermore, while the various definitions of independent directors are well documented, their application in practice to appoint truly independent directors poses problems. Unless this is resolved, their desired effect may not be achieved.

The US corporate board governance model is based on the concept of monitoring and advising by independent directors. Hence independent directors dominate their boards. In contrast, corporate boards in Japan are insider-dominated, emphasizing more on talent and succession development. Managers who have a board seat compete among themselves for the position of chief executive. This is unique to Japan and may be a source of value. It is noted by Coles and Uchida (2017) that, in Japan, the percentage of inside directors younger than the CEO is positively related to firm performance. Also the percentage of junior inside directors is positively related to the frequency of management turnover. US and European corporate governance practice has shown that a larger number of independent directors is not necessarily value enhancing. In some cases a larger number of inside directors can, add higher value, especially among R&D-intensive firms [Coles, Daniel, and Naveen (2008)]. A one-size-fits-all philosophy does not have universal application, including in the US market. Thus, Japan should not necessarily be concerned if its own standards of corporate governance differ from those of the US.

3. Recommendations

1 Japanese companies should seriously consider their optimal board composition taking into account their company characteristics.

2 Regulators should clearly define the concept of an independent outside director for easy and consistent application in practice.

3 Companies should seek highly qualified, capable independent directors with relevant experience. A clear and independent process for evaluating their performance should also be established.

4 Corporate governance interfaces among companies, economies and societies, not just between firms and investors. By focusing on the latter, corporate governance often ignores the former thereby undermining the contribution that the corporate sector makes to economic and social wellbeing. It has to be recognized that corporate governance assists in addressing fundamental issues that nation states, including Japan, will face in the future.

References

Coles, Jeffrey L., Naveen D. Daniel, and Lalitha Naveen, 2008, “Boards: Does One Size Fit All?” Journal of Financial Economics 87, 329-356.

Coles, Jeffrey L. and Konari Uchida, 2017, “Power of Tournament Incentives: Evidence from Japanese Corporate Boards”, SSRN Working Paper: Available at SSRN: https://ssrn.com/abstract=3100444.