A New Japan: the Changing Corporate Governance Regime

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What is Corporate governance, anyway?

• The balancing of interests of many stakeholders:
  – Shareholders
  – creditors
  – Management
  – Workers
  – Customers
  – Suppliers
  – Banks
  – Government
  – The community
Which are the 3 most important stakeholders?

• Customers 90%
• Employees 62%
• Suppliers 30%
• Individual shareholders 29%
• Domestic institutional shareholders 21%
• Foreign shareholders 8%
• Banks 11%

Source: METI IR Survey, 2013
Why is Japanese Corporate Governance a Problem?

• Low profitability, low returns to investors
• Low productivity, decline of competitiveness of workforce
• High cash balances: a drag on investment and on aggregate demand
• Bad governance creates opportunities for fraud, inhibits dynamism, innovation, risk-taking
• Misallocation of resources (no consolidation)
• Barrier to inward FDI
Why is Japanese Corporate Governance a Problem?

Listed Companies’ Cash and Cash Equivalents Holdings
(% of market capitalization; Average between 2004 and 2012)

Sources: Bloomberg
The Abe Administration’s main goals of stronger corporate governance

- Encourage companies to spend cash balances, increase investment
- Raise wages to help exit deflation
- Increase diversity of the workforce
- Increase full-time/permanent jobs
- Support higher stock prices
- GPIF reform to support stock prices, reduce portfolio risk
What can be done/is being done to improve governance?

• New Corporate Governance Code & TSE requirements for outside directors
• Revisions to the Company Act
• New JPX 400 index
• Stewardship Code
• Revision of Corporate Tax Code
• Reform of Government Pension Investment Fund
Company Act: Types of Corporate Organization

- Companies with Committees (US-style)
- Companies with Board of Statutory Auditors (“kansayaku”)
- New category: Company with audit/supervisory committee
- New definition of “independent director”
Corporate Governance Code/Stewardship Code

• “comply or explain”

• Stewardship code requires of investors:
  – Active dialogue with management of invested companies
  – Disclosure of conflicts of interest
  – Transparency of voting policy
Benefits of improved governance

- More disciplined allocation of resources
- Consolidation and rationalization of companies
- Rise of the professional CEO
- Shift to a merit-based system of pay/hiring
- Increase of global competitiveness
- Decline in the power of the mega-banks
- Rise of a professional fund manager class in Japan
- More adversarial corporate/government relationship?
Costs of Improved governance, need for policy response?

- increase of income inequality
- Reduction in job stability
- Faster shift of resources outside of Japan
- Downward pressure on wages
- Reduction in level of customer service
- Increase in bankruptcies
- Decline in loyalty to the employer
- Institutional Investors will dominate the markets
Countervailing Currents

- GPIF Reform
- Government paternalism
- Corporate IR/competence and tenure
- Short life of US yen equity managers (2-3 yrs)
- Timing of Shareholder meetings
- Takeover rules/bankruptcy (Prepackaged) and legal (discovery)
- Boards: pay, language, offsites
- “Comply or explain”
Conclusions/Early reactions

• More than 100 companies have signed the Stewardship code, including GPIF
• Fanuc
• Kagu
• Resistance to buybacks
• First female Keidanrenren executive
• Impact of GPIF/BoJ?
Percentage of Corporations Appointing Independent Directors, TSE-1

- Total # of Corporations (first section of TSE)
- # of Corporations Appointing Outside Directors

Year | Total Corporations | Appointing Outside Directors
-----|--------------------|-----------------------------
2004 | 1610               | 487                         
2005 | 1,664              | 582                         
2006 | 1,744              | 682                         
2007 | 1,726              | 759                         
2008 | 1,723              | 775                         
2009 | 1,698              | 787                         
2010 | 1,672              | 806                         
2011 | 1,668              | 529                         
2012 | 1,676              | 577                         
2013 | 1,752              | 857                         
2014 | 1,816              | 908                         

Total increase: 262 in 2014

Total increase: 302 in 2014
Foreigners pressure for more outside directors

Foreign Investors: less than 10%
- 1 person: 52.2%
- 2 persons or more: 2.5%
- 3 persons or less: 6.0%
- 0 persons: 0%

Foreign Investors: 30% or more
- 1 person: 39.2%
- 2 persons: 24.1%
- 3 persons or more: 18.5%
- 0 persons: 30.1%
Why is Japanese Corporate Governance a Problem?

<table>
<thead>
<tr>
<th>Table 1. Number of Bankruptcy Procedures in Selected Countries (2003—12)</th>
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<tr>
<td>United States (Chapter 11)</td>
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<td>Japan (Reorganization)</td>
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Source: Kinoshita (2014)