Changing Corporate Governance

Nicholas Benes

NICHOLAS Benes is Representative Director of the Board Director Training Institute [BDTI]*1. As the initial proposer of Japan's first Corporate Governance Code, the governance indicator for listed companies, Benes here shares his views on foreign direct investment (FDI) in Japan in terms of corporate governance and business management systems.

How do you assess the impact so far of governance reforms on portfolio investment in Japan? On FDI in Japan?

In terms of very concrete results like raising ROE [return on equity] and streamlining corporate strategies, so far the impact has been small. But this is no surprise, because the benefits of better corporate governance take time to occur in any country.

In terms of changing public attitudes and putting in place the basic infrastructure needed to accelerate change, Japan has made a lot of progress. I think few developed nations have put in place a corporate governance code in as short a time as Japan did, and nowadays the bookstores are full of books with words like "governance code," "stewardship code," "ROE," and "ROIC" [return on invested capital] on their covers. Multiple "sea changes" are underway.

The questions to ask now are: (a) can the government keep up its momentum and put in place the policies that are needed in the *next* stage; and (b) will institutional investors – both foreign and domestic – actually *use* the new infrastructure to influence companies enough? To do this, they will have to actively vote their shares so as to praise the firms that put in place effective governance practices, while not re-electing directors at the companies that do not do so.

The impact of the reforms on foreign direct investment will take time to become visible. That impact will come when more companies focus their strategies by selling off non-core affiliates and holdings, either to foreign companies or to private equity firms that sell them to foreign companies later on.

What reforms are "working"? What reforms are not?

Some of the reforms have had a visibly positive impact. In general, many companies no longer consider "corporate governance" to be something that they can ignore. Because of the creation of a corporate governance code, improving governance is now seen to be "a necessary and good thing." And certain specific code features, such as disclosure about policies and practices, the requirement to appoint "multiple independent outside directors" and the principle that boards should conduct a self-evaluation process, have changed many firms' governance practices and set the base for further change.

But in the absence of greater discipline from investors, I would say that most companies still approach many important concepts in the code in a minimalist and almost lackadaisical manner. The use of committees, director nomination qualifications and director training would be examples.

To me, the part of the reform process that is

Photo: Courtesy of the Board Director Training Institute of Japan not working well enough yet is the "stewardship and engagement" wheel of the cart. Institutional investors need to set forth clearer, more concrete examples of the kind of corporate governance practices they are expecting, in writing. But most of them are not doing this.

In the next phase of Japan's transition, what issues need to be addressed by companies?

Companies need to realize that nominations committees that are not solely made up of independent outside directors will not be trusted by investors. Next, they need to understand that no nominations or executive appointments process can hope to be effective without healthy competition for executive positions that is based on objective performance evaluations, rather than private discussions and subjective appraisals.

In the future, a significantly larger proportion of managerial compensation will be performance-linked. Companies need to revamp their HR [human resources] policies to fit with that fast-coming reality. Right now, many Japanese companies do not have HR systems for evaluating and promoting managers, including foreigners and women, that allow them to manage as superior global firms attracting the best talent from around the world – including from outside the firm.

It is only a matter of time before much more active proxy voting punishes executives who cannot show HR practices and systems that are designed – and functioning – at a modern standard.

What issues need to be addressed by policy?

At this point, the Corporate Governance Code needs to be revised so that it is more specific as to what constitutes "best practice." The code should state that a majority of directors should be high-quality independent outside directors, on a comply-or-explain basis. Research done by BDTI and Metrical Inc. [a company engaged in corporate governance research] in Japan, and by academicians looking at other countries, shows that such firms tend to out-perform.

The recent revision of the Stewardship Code was a step forward in one area in particular: the general suggestion that signatory institutions should disclose their proxy voting records in detail. However, clearer "sanctuary" rules for collective engagement by investors are needed.

Most of all, everyone needs to recognize that the Stewardship Code will not be a full success unless corporate pension funds are essentially required to sign it in large numbers, and we have a "Japan ERISA*2 Law" to guide the fiduciary duties of such funds. Pension funds are the largest source of money to fund managers, so the fund managers will listen to them and increase their "voice" if they are asked to. But so far, only one pension fund of a non-financial corporation has signed the Stewardship Code, and most companies are simply waiting for the pension funds at two iconic firms, Toyota or Panasonic, to sign it. This should not be happening in a country where companies claim to value their employees in most other respects.

Are investing institutions and executives keeping up with the pace of reforms?

No, quite frankly they are not. More learning on both sides of the investment equation needs to take place. But very, very few fund managers have ever sat on a board, so they are unsure how to go about engagement and active proxy-voting. Without more pressure from investors, many companies do not take governance and director training as seriously as they need to.

What is the upside?

The upside is huge. I daresay that average ROE and long-term corporate productivity could both double if Japan gets governance functioning up to its potential. The downside is also huge, if Japan cannot keep up its momentum and make that a reality.

Interview by HITOSHI CHIBA

Note

1 Established in 2009, the Board Director Training Institute of Japan (BDTI) is the only certified public-interest non-profit in Japan dedicated to facilitating the safe, sustainable and ethical development of the Japanese economy and Japanese companies by improving corporate governance. Here, Mr. Benes expresses his own personal opinions, not those of any organization.

2 Enacted in 1974, the Employee Retirement Income Security Act (ERISA) is a federal law that provides for unified design and operation of company pension plans and benefit programs.