Corporate Governance Matching Japan's Economic Society Required

Establish Rules Conforming to Global Markets

Interviewer: Hiroshi OKABE

Japanese businesses are under pressure to transform their corporate governance structures amid ongoing economic globalization. What is needed to transform the so-called Japanese model of business management in order to improve transparency and efficiency of management? What should be done by Japanese companies to transform the structure of boards of directors, increase returns to shareholders, and cope with merger and acquisition (M&A) offensives from foreign firms? In an interview, Masaharu Ikuta, who was the first president of Japan Post when it was corporatized in 2003 after serving as president and chairman of Mitsui O.S.K. Lines Ltd., talks about the future course of management reform of Japanese corporations.

You are one of the founding members of the Japan Association of Corporate Directors comprising front-line business managers. Currently, as vice chairman of the association, you continue to speak out aggressively on appropriate corporate governance for Japanese businesses. From your long career in this field, how do you see current management reform efforts by Japanese firms?

Ikuta: There are various aspects in corporate reforms in Japan. One is structural reform to improve profitability, and another is improvement of corporate governance. Reform in terms of corporate governance has made significant progress, yet it is still in the middle of the course as a whole. And, in some cases, corporate governance reform is achieved only in appearance and lacks substance. I think Japanese companies need to create and entrench a corporate governance mechanism conforming to Japanese corporate society.

Outside Directorship Immature

Photo: Kyodo News

Masaharu Ikuta,vice chairman, Japan Association of Corporate Directors

An increasing number of Japanese companies have appointed outside directors as part of efforts to improve the transparency of corporate management. Do you think such an external directorship is functioning well? What is your opinion about the current situation?

Ikuta: In Japan, a growing number of companies have followed the US model of management in appointing outside directors. However, of all the 2,356 companies listed on the Tokyo Stock Exchange (as of October 2006), only 42% have external directors on their boards. Of those having outside directors, the number of such directors per company stands only at around 1.9 on the average. This means that at a company with about 10 directors, 80% of them are insiders. This is a reversal of American firms where 60%-80% of board members are outsiders. It is a fundamental rule of corporate governance for outside directors to check management. In the current situation, however, external directors are not allowed to fully perform their functions. I think Japanese companies should appoint at least three to four outside directors on their boards. Then, tension would mount among outside directors. They could properly reflect shareholder views on the board through an exchange of opinions.

It may be one of the characteristics in the Japanese model of management to pick directors from among in-house members alone. Is the system of outside directorship still immature in Japan?

Ikuta: What is important is what sort of people are outside directors. In the United States, outside directors are usually picked from among prominent businessmen who once served as chief executive officer (CEO) at other companies, professionals such as lawyers and accountants, and academics. A considerable number of Japanese companies are moving to do like that. But many incumbent CEOs also concurrently serve as outside directors of other companies. This is a problem. Incumbent CEOs should spend all of their time and energy for their own companies and make efforts to develop them. They must have no time to spare as outside directors at other companies. In Japan, however, not a few incumbent CEOs assume external directorship. In some cases, a single CEO concurrently serves as outside director at many other corporations. Business executives ought to realize their dignity and responsibility as CEO more deeply. In the United States, incumbent CEOs never assume directorship at other companies in principle. If they are forced to do so out of necessity, they limit the number to one or two. Even in such a case, I understand those CEOs take due procedures, explaining to their own boards why they must assume outside directorship, thus fulfilling accountability and obtaining board approval. In this sense, Japanese corporations are establishing outside directorship on the surface but its substance has yet to come. I think the self-awareness of CEOs in this field is still immature in Japan.

Outside Views Essential to Management Control

More than half the listed companies in Japan have yet to introduce outside directorship. Even some global corporations that are industry leaders have no external directors on their boards.

Ikuta: Certainly, there may be no need to appoint outside directors if the objective is only to improve profitability. But management control by outside directors becomes important when companies fail to achieve steady business results or when they are involved in a severe competition with rivals. Japan has recently seen a series of corporate scandals, such as false labeling of foods. Among them are prominent firms that no one would imagine would commit such misconduct. In many cases, firms are involved in scandals when their business performance is on the downturn. I think an outside directorship mechanism can prevent many of such scandals from happening. Firms never commit scandalous acts when they are in a good business condition, but may happen to be involved in scandals when business competition turns severe. If there are in-house directors alone on the board, I am afraid it may become impossible to stop the CEO from moving in a wrong direction when he or she hesitates to make the right decision.

Quite a few companies have established US-style corporate committees mainly formed by outside directors in a bid to tighten governance and strengthen control on management. I wonder if the increase in the number of companies with such a committee-based corporate structure can be regarded as part of moves to follow US-style corporate governance. How do you evaluate the present situation in Japan?

Ikuta: In Japan some companies have established committees on nomination, remuneration and audit in accordance with the US model. However, this style may be a little bit impracticable for Japanese companies whose boards include only two to three outside directors. In many cases, a single external director concurrently sits on two or more committees. I think the committee system itself is a good thing. To make it effective, however, more studies must be done on the number of outside directors and other matters. Mitsui O.S.K. Lines, which I once headed as president, appointed three outside directors but did not establish such committees. Instead, we constantly consulted with all the outside directors about personnel affairs and other aspects of management to seek objective opinions.

Eyes Maximizing Corporate Value

It used to be called characteristic of Japanese corporations to attach importance to employees. However, the importance of placing emphasis on shareholders has been pointed out, and a major change has been seen in Japanese business philosophy. What is your view on such a shift? Moreover, Japanese companies face successive demands from shareholders, particularly investment funds, for increased dividends. Some Japanese firms harbor a sense of crisis in that sticking to the stockholder-first principle alone would not lead to establishing "strong companies" from a long-range perspective. Which area of corporate management do you think should be given priority?

Ikuta: I think all that can be said is to attach importance to stakeholders. The sense of balance is important and, to satisfy shareholders, companies must satisfy other stakeholders. The US model of management is said to focus on the pursuit of short-term profits on a quarterly basis, but I think it is wrong if it aims to seek only short-term profits. In the United States, healthy managers are considering how to ensure medium- to long-term corporate values. If asked to say what is important, I would say that it is to seek maximization in medium- to long-term corporate values. If Japan's traditional employee-first management encourages employee morale as a result and helps them work harder, apparently somewhat larger profit distribution to them will lead to maximization of corporate values in the medium to long term. And if it leads to an engine to achieve the company's growth, it will mean the company placed importance on shareholders in the long run. What is important is not to attach emphasis to any particular stakeholder but to maximize medium- to long-term corporate values.

Based on this concept, it is the insight of business managers to consider which stakeholder should be given priority in response to the prevailing business environment each time. My belief is that business is based on humans. No company can achieve growth unless its employees are motivated.

Major Gap in Top Management Structure in Japan & U.S.

Japanese companies have strengthened corporate governance following in the footsteps of their US counterparts. I doubt, however, that such an imitation would help Japanese companies establish their own corporate governance system conforming to Japan socioeconomic needs.

Ikuta: The United States has spent more than 30 years to establish corporate governance. The Japan Association of Corporate Directors has continued activities to make corporate governance take root in Japan. I think there has been considerable progress in the past few years. But it differs from the United States in terms of maturity. Long experience over there serves as a major reference for Japan. I think US experiences should be respected. However, we must be cautious not to introduce the US style of corporate governance just as it is. Foreign equity holdings in some Japanese companies are high and these firms have to be rated by the US market. They may need to adopt US-style governance in its exact form. Other companies need to consider introducing a corporate governance structure in a way conforming to Japan's economic society.

Would you specify differences between Japan and the United States?

Ikuta: For example, there is a market of business executives in the United States. US corporations can easily change their top management with a board decision. Therefore, American managers are held responsible for relatively shorter-term earnings than Japanese business executives. In Japan, a single CEO seldom migrates from one company to another. Japan has so far seen no such market of business managers. In many cases in Japan, long-serving employees who produced good results tend to head companies, except for some firms such as venture businesses. There is a major structural difference in the top management echelon between Japan and the United States. It is important to study the US model of corporate governance and establish a Japanese style matching our economic society, while bearing the difference between the two countries in mind. Because of a lack of experience, I cannot say definitely yet what type of governance is good.

Japanese Style Based on Longer-range Viewpoint

It is important to take a risk in corporate management to strengthen innovation, isn't it? I think it will be a key to revitalizing the Japanese economy.

Ikuta: I agree in principle. In Japan, however, a long-serving employee who has considered the company's medium- to long-term interests becomes the CEO. In the United States, a CEO abruptly comes from the outside, talks a great game, and takes a make-or-break decision. Japanese CEOs will never do such a thing. Japanese business executives are steady in management, considering corporate matters from a medium- to long-range perspective. Various in-house checking functions are effective at Japanese companies. I think Japanese executives are engaged in business management taking risks on a reasonable scale. I believe the odds of success are higher under steady management in which risk factors are taken into full consideration. The US style of inviting a CEO from the outside and trying to improve management efficiency while taking major risks will not always prove to function smoothly. If there are to be industries where such a style may succeed, an example will be the information technology (IT) field. Meanwhile, the financial service sector, which I would say is the last industry under government protection in Japan, lags in management reform. Japanese financial service providers differ in management from their US counterparts. There is a major difference in the density of know-how between the Japanese and US financial service sectors, although some innovative managers are showing up in the Japanese financial sector recently.

Information-related functions such as the post of chief information officer (CIO) are becoming important in the wake of rapid progress in the use of IT to collect, sort out and utilize information for corporate decision-making. How do you see this?

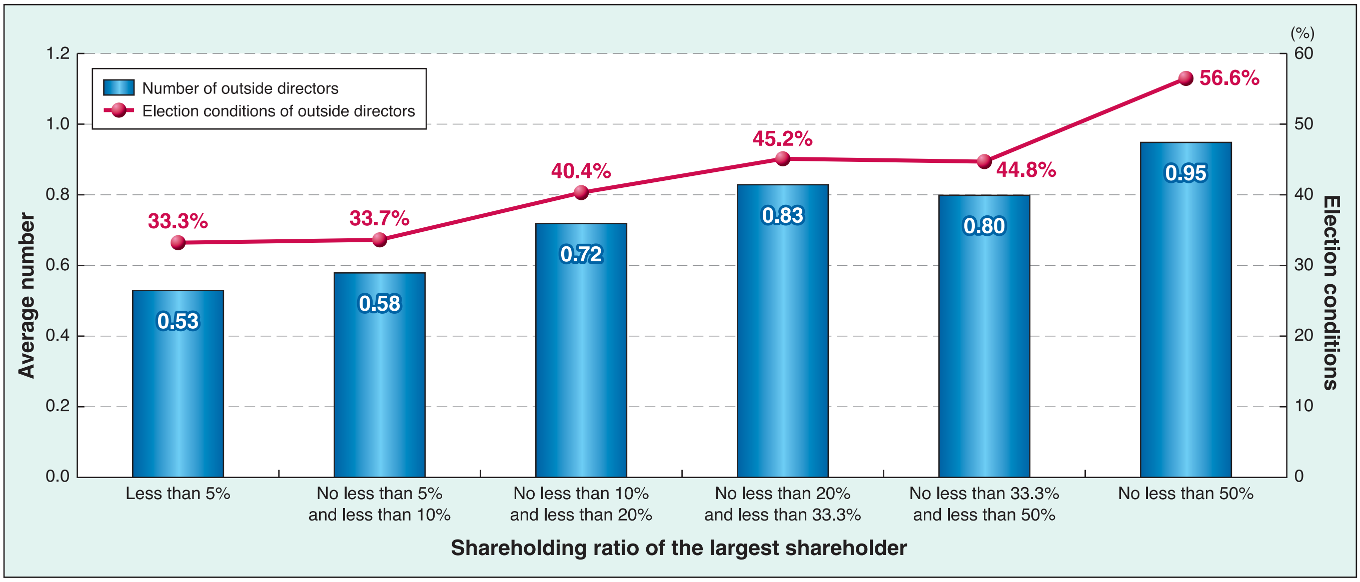
Ikuta: It is a good idea to establish the CIO post because the role of information is becoming more and more important. In many cases, promising figures seen as future presidents are serving as CIO at Japanese corporations. But there may be such arguments that not only the CIO but the chief financial officer (CFO) and the chief ecological officer (CEO) are also important. In such a situation, the management structure will be almost the same as the conventional system of role-sharing by board members. If asked to say if I am affirmative to the post in charge of IT, I would say basically yes. However, if a similar way of thinking spreads to other fields, it will lead to confusion. I would like to say corporations should think out the matter before taking action.

Defense Steps Precluding Foreign Firms Wrong

M&A bids by foreign businesses are expected to increase in the wake of recent legal revisions that included

Chart Election of outside directors and numbers elected

(Companies with corporate auditor system; shareholding ratio of largest shareholder)



Source : *"White Paper of Corporate Governance 2007," Tokyo Stock Exchange*

the lifting of a ban on the so-called triangular merger scheme. Do you think such moves will help revitalize Japanese companies? Japanese firms have introduced defense measures against foreign buyout attempts one after another. What is your view about these moves?

Ikuta: What is important is to establish rules that conform to global markets – in other words, rules that are similar to those in other countries. Based on this precondition, I think the matter should be left to the market. I believe buyout moves should never be encouraged nor regulated forcibly, but market rules should be allowed to govern. The triangular merger scheme is OK. When such a large number of Japanese companies are doing business in many foreign countries, Japan must not follow protectionism. Moves against M&A bids may leave the firm targeted by foreign companies to feel protected but would only lead to the loss of competitive power of the Japanese economy and its eventual decline. So I think we had better have the triangular merger scheme. We may leave it to international competition.

Is the Japan Association of Corporate Directors planning to get involved in these problems actively?

Ikuta: We are scheduled to set up an M&A committee to discuss what sorts of rules should be in place. Japanese judicial authorities declared legal the defense measures launched by Bull-Dog Sauce Co. against a takeover attempt by US investment fund Steel Partners. Is it OK to allow that court decision to be established? I think we should deepen discussions on whether the court decision was a proper one in terms of truly raising Japan's international competitiveness. The Japanese economy cannot grow under such protectionist conditions. M&A and triangular merger moves would give stimulus to help companies make more efforts to maximize their corporate values. Protection from a short-term point of view would only undermine the Japanese economy.

Japanese corporations appear to be strongly cautious against investment funds.

Ikuta: There are no powerful funds in Japan. On the global stage, however, funds have grown into a major industry. Some funds are doing healthy operations while others are not. Some are operated in a healthy manner and contributing greatly to economic revitalization. On the other hand, there are funds pursuing only short-term profits. A decision based only on negative aspects of these funds may lead to a major mistake. Rejection of a powerful industry would bring about a disadvantage to those who reject it. Still more, sovereign wealth funds that manage government funds are gaining strength recently. We are in an era when such funds are operated as a national strategy. We are no longer in a situation permitting discussions on whether these funds are good or not. I would like to see fund operators establish a healthier code of conduct. And we need to consider how to keep friendly ties with funds.

How do you appreciate the impact that the so-called Japanese model of management has had on foreign countries?

Ikuta: Employee-first management brought about some positive effects on foreign countries. Such a model of management has helped raise the motivations and morale of employees and led to an improvement in business performance. It is effective not only in Japan but also abroad. JS

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