Japan's Evolving Corporate Governance System

Is There a New Model of Japanese Management?

By Christina L. AHMADJIAN

Japanese management has received much attention over the last few decades. In the 1980s, managers around the world eagerly studied Japanese companies, hoping to discover the secrets to the astounding success of Japan's postwar economic development. Unfortunately, after the burst of the asset bubble in the early 1990s, Japanese management became a cautionary tale – an example of what not to do. With the beginning of a revival of the Japanese economy, and the ongoing success of many global Japanese firms, Japan is attracting interest again. The focus this time is on change. Have Japanese firms changed their management practices in response to the recession of the 1990s and increasing globalization? Is there a new model of Japanese management?

Japanese management is a vast field, and it is impossible to cover all of the latest developments in a single article. However, if we were to identify one of the most important, influential and controversial changes in the landscape of Japanese management, it would be corporate governance. Corporate governance has been one of the most hotly debated topics in Japanese business for most of the last decade. Should Japanese firms adopt US-style corporate governance practices such as independent directors? Can Japanese firms adopt some aspects of US-style governance and ignore others? Are corporate governance reforms necessary in the face of increasingly globalized financial markets? Even after 10 years of debate, there is still little consensus on the answers to these questions. But, there is increasing evidence that a new model of corporate governance is emerging in Japan. This system is very different from US-style governance, and is also very different from the Japanese system that dominated the postwar period. What does this new model look like, and what are its implications for Japanese management?

A Collision of Business Systems

Corporate governance is at the very center of a nation's business system. Corporate governance consists of a set of ideas about the purpose of a firm and how it should balance its obligations to stakeholders such as shareholders, employees and the community. Corporate governance is also a set of systems and mechanisms that monitor managers and motivate them to behave in the interest of whatever stakeholders are deemed most important. These include boards of directors, executive compensation systems and financial reporting standards.

In the postwar period, Japanese corporate governance emphasized the firm as a community of employees, wrapped in close relationships with customers, business partners and financial institutions. At the center of this system was permanent employment, in which large firms assured their employees a job until retirement age. Another feature of this system was cross-shareholding, in which friendly companies and financial institutions acted as stable shareholders, holding large percentages of a firm's shares with an implicit promise that they would not sell this stake. Firms were dependent on banks for financing, and banks kept close watch to assure that companies could pay back their loans. Boards of directors in Japanese companies tended to be very large, and were dominated by insiders with operating responsibilities, such as the heads of functions and important business units. A board of statutory auditors, or *kansayaku,* was in theory supposed to monitor the board but, in practice, the *kansayaku* had a vague mandate, and virtually no power.

The Anglo-American system of corporate governance (often referred to in Japan as "US-style" governance), in contrast, places top priority on shareholders, and emphasizes a firm's duty to "maximize shareholder value." Employees are generally considered assets to be hired and fired as necessary. Similarly, shareholders can do the "Wall Street walk" and sell their shares when they were not happy with a firm's performance. Firms are highly dependent on equity markets for financing, and a board of directors, dominated by independent directors, looks after the interest of shareholders.

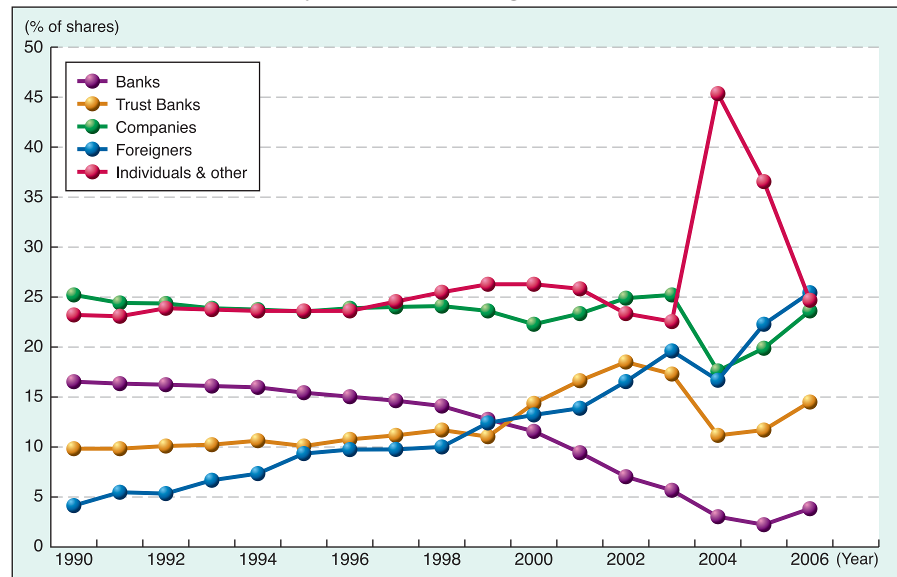
In the mid-1990s, Japanese firms began to come under pressure to adopt US-style governance practices. Foreign investors, many of them US and British investment funds, dramatically increased their holdings of Japanese equities. While foreigners held only 4.2% of shares listed on the Tokyo Stock Exchange in 1990, this increased to 25.4% by 2006 *(Chart 1).* Foreign investors demanded that Japanese firms adopt governance practices predominant in the United States, and increasingly in Europe and developing Asian economies, such as independent boards and more attention to shareholder value. Some Japanese executives, most prominently, the Corporate Governance Forum of Japan, also began to advocate increases in independent directors, smaller boards and more transparent financial reporting.

Changes in the legal and economic environment also made it difficult for firms to maintain the postwar system of governance. The Financial Services Agency introduced new rules that made cross-shareholding costlier and more risky, and demanded greater transparency in financial reporting. Banks, facing a bad loan crisis, increasingly sold off the shares that they had long held in companies, leaving firms more vulnerable to demands of foreign investors.

Japanese executives lined up on both sides of the governance debate. Some strongly supported adoption of US-style governance practices while others passionately defended the Japanese system

of the company as a community, controlled by insiders. In 2003, the Ministry of Justice resolved this debate by introducing an unprecedented revision to company law that allowed firms to choose between governance systems. A firm could chose either the "board with committees" system, requiring it to establish on its board of directors three committees, nominating, compensation and auditing, which were to have a majority of independent directors. Alternatively, firms could retain the existing Japanese system and retain an insider-dominated board plus a board of statutory auditors. These new regulations ran counter to the trend in both developed and developing economies around the world towards mandating independent directors. It reflected the deep ambivalence that Japanese managers held towards independent directors. These regulations also mean that Japan probably has the greatest diversity of governance practices of any developed country today.

Chart 1 Changing composition of shareholders in Tokyo Stock Exchange-listed firms



Source : *"TSE 2006 Shareownership Survey," Tokyo Stock Exchange*

The US Model of Governance Fails to Take Root

Despite the great fanfare that surrounded the introduction of the board with committees system, this new system has failed to make inroads in Japan. As of 2007, only about 5% of the companies listed on the Tokyo Stock Exchange had adopted this system. Since the board with committees form is widely referred to as "US-style" governance in Japan, this would suggest a failure of the US system to take root. Further evidence of the failure of Japanese firms to adopt US-style governance is apparent in the composition of boards that have adopted the committee system. For example, Hitachi, one of the first adopters of the board with committees system, has only five independent directors on a board of 13 members – which would be considered an excessively insider-dominated board by American standards. Even Orix, considered one of the most enthusiastic advocates of US governance practices, has only five independent directors on a board of 11.

Japanese companies also have mostly resisted the message to "maximize shareholder value" that is preached in US business schools and advocated by foreign investment funds. It is very rare to find a Japanese executive who is willing to say that his firm is striving to maximize shareholder value. Yet, there has been a real sea change in the attitude of Japanese managers, who have gone from largely ignoring shareholders at best, and at worst considering shareholders other than friendly companies and financial institutions to be little more than gamblers, to including shareholders along with employees, customers, business partners and the community as important stakeholders. An executive of a leading firm expressed to the author an opinion widely held among Japanese executives: "The board represents shareholders, the community, employees and customers…really, we have to consider all the stakeholders." This change in attitude towards shareholders reflects a new reality for Japanese managers – that their shares are no longer safely in the hands of friendly companies and financial institutions, but are increasingly held by foreign and other investors, who are more interested in making a profit than cementing a long-term relationship. But many, if not most, Japanese managers also have a visceral resistance to the idea of placing shareholders above other stakeholders.

Emphasis on Execution over Monitoring

The failure of the US system of corporate governance to take root does not mean that there have not been major changes in the Japanese corporate governance system. In fact, many Japanese firms have overhauled significantly the structure and function of their boards of directors, and their entire decision-making systems. Perhaps the most important new trend in this area is called the "corporate executive officer," or *shikko yakuin,* system. Sony was the first to introduce this system in 1997, reducing its number of directors from 38 to 10 by removing most directors with executive responsibilities from the board and renaming them "corporate executive officers." This practice spread rapidly, and by 2007, 51% of firms listed on the Tokyo Stock Exchange had adopted this system. This led to a significant decrease in the size of boards of directors of Japanese firms. In an analysis of 400 large firms, the author found that the average board size decreased from 25 to 17 members between 1990 and 2000.

The rationale for removing executive officers from the board and calling them "corporate executive officers" was to improve the speed and transparency of decision-making. One director inter-

viewed by the author described the problem with the big boards of the past: "With 30 or more board members, it was hard to expect anything to get done in the board meeting – it was like an elementary school class. Things were determined beforehand, and the point was to make board meetings very simple, with very little documentation, so things would proceed smoothly. All the decisions were made in informal meetings before the board meeting so there was no documentation on how the decisions were actually made."

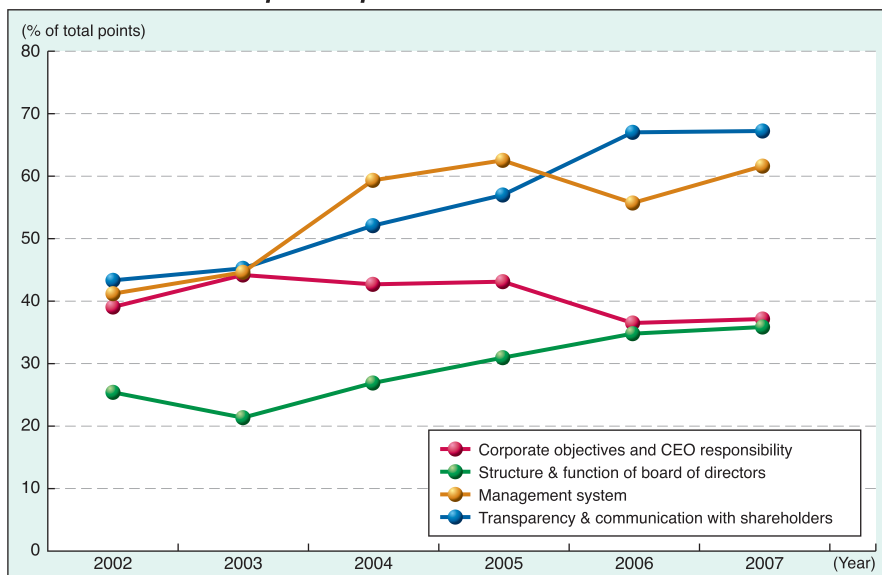
The introduction of the board with committees system and the reduction of board size have important implications for how Japanese firms make decisions. The emphasis in many firms has been to push decision-making as much as possible down to the level of a business unit, leaving boards of directors to set strategic directions and monitor the progress of execution plans. Firms are clearer about who is supposed to be making what decision, and there is far greater transparency surrounding the decision-making process, at least according to reports by managers themselves. Managers say that decision-making is less consensus-based than in the past, and there is greater individual accountability.

While the introduction of the corporate executive officer system seems to be an important development, the implications for corporate governance are unclear. One of the fundamental pillars of corporate governance is the separation between monitoring and execution. The idea is to establish an independent body to monitor managers who have responsibility for execution. The corporate executive officer system has made executive responsibility much clearer. By reducing the size and number of decisions that have to be made by the board of directors, it has made the board more flexible and better able to rapidly respond to changing business conditions. But the monitoring capability of the board of directors has hardly changed at all, and there are very, very few boards in Japan that could be called truly independent.

Japan Corporate Governance Index Survey: Assessing Current State of Corporate Governance in Japan

More concrete evidence of this gap between increasingly better execution and relatively undeveloped monitoring can be seen in the results of the Japan Corporate Governance Index survey that the author and colleagues have conducted on firms listed on the Tokyo Stock Exchange first section annually since 2002 (www.jcgr.org). The survey assesses the degree to which firms have adopted a "global standard" of corporate governance, consistent with principles set forth by the Japan Corporate Governance Forum and the OECD (which feature independent boards and transparent financial reporting, among other things). The Japan Corporate Governance Index is comprised of four components: 1) the degree to which a CEO sets clear objectives that are aligned with shareholder interests and is accountable for achieving these objectives, 2) the degree of independence of the board of directors, 3) the management system, or system for execution and internal control, and 4) transparency and communication with shareholders. *Chart 2* shows how the firms that responded to our survey have fared on each of these four components over time. We see that as of 2007, there is a strong divergence. In general, firms have been developing their execution and internal control systems and have improved greatly in transparency and communication with shareholders. In contrast, the structure and function of boards of directors, particularly independence, have lagged considerably, as has the degree to which a CEO sets clear objectives aligned with shareholder interests.

Chart 2 Average achievement rate of 4 components of Japan Corporate Governance Index

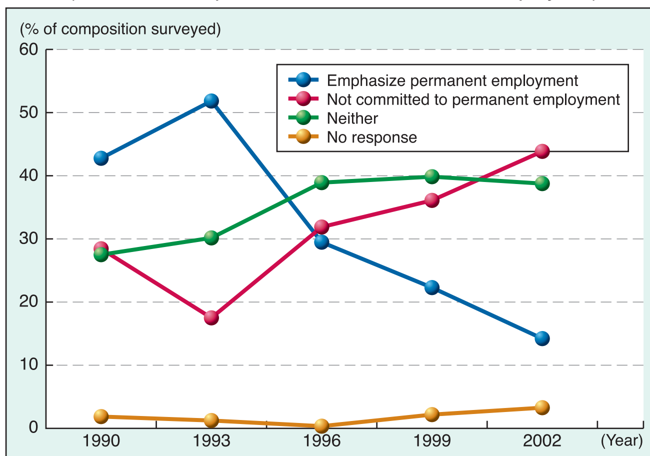


Source : *Japan Corporate Governance Research Institute (www.jcgr.org)*

What About Employees?

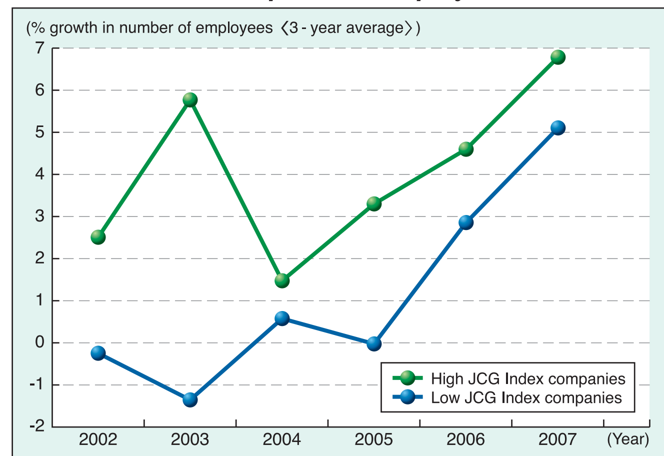
One of the central features of a corporate governance system is the status of employees. In the postwar Japanese system, employees were part of the company community and the permanent employment system was deep rooted, at least in large companies. One of the most controversial aspects of corporate governance reforms in Japan is their effect on employees. Many opponents of US-style corporate governance reforms have argued they will harm the permanent employment system, thus destroying one of the essential strengths of Japanese management. This raises several questions: first, whether or not corporate governance reforms have been introduced at the expense of employees and, second, whether Japanese firms are retaining the permanent employment system.

Chart 3 Large companies decreasing their commitment to permanent employment
(results for companies with more than 5,000 employees)



Source : *Annual Employment survey, Ministry of Health, Labor and Welfare*

Chart 4 Corporate governance reforms don't come at the expense of employees



Source : *Japan Corporate Governance Research Institute (www.jcgr.org)*

The question of whether Japanese firms are retaining permanent employment or not has been the subject of much debate. In the 1990s and 2000s, firms drastically restructured their workforces through encouraging early retirements, assigning employees to related companies, reducing hiring of permanent employees, and increasing hiring of temporary employees. In recent years, many firms have claimed they are no longer committed to maintaining the permanent employment system *(Chart 3)*. On the other hand, firms seem to have maintained the idea of retaining permanent employment, or at least an assurance of long-term employment, to a core group of employees. While restructuring was once seen as a necessary means to recover from recession, laying off employees to weather short-term economic downturns or improve returns to shareholders may never find fashion in Japan.

It is also not clear that corporate governance reforms are as intertwined with employment policies as opponents to reform would argue, and there is evidence that such reforms have not come at the expense of employees. For example, an analysis of firms that scored high (one standard deviation or more above the mean) and firms that scored low (one standard deviation or more below the mean) in the Japan Corporate Governance Index shows that the high-scorers consistently showed greater growth in the number of employees than the low scorers *(Chart 4)*.

A New Model of Corporate Governance for Japan

Above, we have outlined several features of a new model of corporate governance and management in Japan. There is an emerging consensus that firms should be given freedom to choose the management and governance style that best fits their needs and that company law should not restrict firms, but rather should give them increased options. Firms are paying increased attention to shareholders, through improving communication and transparency of reporting. In sharp contrast to the past, they consider shareholders to be an important stakeholder, but still, few firms consider shareholders as more important than customers or employees or the community. Firms have changed their decision-making structures, establishing systems to make accountability for decision-making clearer and more transparent, and pushing operating decisions downwards while centralizing strategic decision-making within a smaller and more flexible board of directors. The scope of the permanent employment system has decreased, and while the system has not disappeared, companies are less willing to see this as a central pillar of the Japanese system of management that must be preserved at all costs.

What is missing in all of this is monitoring. In the postwar system of Japanese governance, firms were dominated by insiders, decisions were made by consensus, and strategic decisions were often based on imitation of foreign or domestic competitors. Firms operated under the watchful eyes of their banks, business partners, stable shareholders and government ministries. That era is clearly over, and these older monitoring bodies are no longer effective. Yet, as strategic decisions get riskier, the global business environment becomes more complex, and Japanese firms are increasingly leaders rather than followers, new forms of monitoring have not kept pace. The decrease in the size of boards of directors has arguably given more power to a smaller number of top executives – but it is not at all clear who monitors them.

The Enron crisis in the United States has exposed the weakness of presumably independent boards of directors. Even in Japan, companies that on paper appeared to have adequate monitoring systems have experienced scandals. Yet, this is further evidence of how important it is that firms not only have well-designed and transparent systems for execution but also systems to monitor the executive decisions. While the emerging model of Japanese corporate governance and management has many strong points, it is quite lacking in this aspect, and this is a source of concern for the ongoing health of Japanese firms and of the Japanese economy. JS

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