Towards New Corporate Governance in Japan: Positive Move or Partial Loss of a Fruitful Singularity?

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"Abenomics" includes a set of decisions that are essentially macroeconomic driven, especially to counter the deflationary pressures that have been current for some time in Japan. But this major economic and political ambition also concerns the corporate sphere. Thus, at the microeconomic level, Abenomics aims to install a new model of corporate governance with a key point regarding time scale. Indeed, it should be erasing the traditional logic of long-term stakeholders to encourage a short-term approach whose central thermometer is return on investment (ROI), a major concern for shareholders and investors.

Faced with this profound paradigm shift, we need to ask four questions:

1) Was the traditional model of Japanese governance so outdated or negative that it needed to be abandoned?

2) Can the reptilian slough from one system to the other be performed without generating financial and economic inequalities?

3) Will joining the mainstream of Anglo-Saxon capitalism be a boon for Japan?

4) Should Japanese elites succeed in inventing a "policy mix" concerning corporate governance?

I will address each of these in turn.

1. Was the traditional model of Japanese governance so outdated or negative that it needed to be abandoned?

No one can deny the Japanese success story when the country had a GDP of $4.9 trillion and global companies whose innovation and efficiency are well-known and reputable. But this success, which dates back nearly 40 years, took place under an original model of corporate governance — in fact, a single model all over the world.

Corporate governance refers to the organization of the control and management of a firm. To be more accurate, the term corporate governance is used to describe the relationship between shareholders and the company management.

So the operations of the board of directors are required to ensure transparency and integrity in order for the information provided to shareholders, markets and regulators to be effectively credible and sincere. Typically the objectives of the new corporate governance (since the turn of this century) are the principles that govern the famous US Sarbanes Oxley Act and the precepts of the OECD.

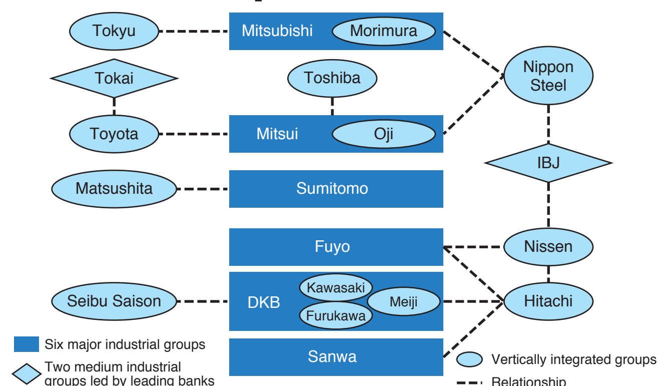
Concerning Japan, its model has largely given way to state intervention. Due to the actions of the trade and industry ministry, there was policy coordination among investment firms in high value-added sectors. The state and the banks have developed a long-term vision that has achieved sustainable growth. In fact, often Japanese firms belong to a *keiretsu* (a group of companies with interlocking relationships and shareholdings), such as banks like Mitsubishi, Mitsui, Sumitomo, and Sanwa *(Chart 1)*. Although their shares are quoted on the Tokyo Stock Exchange, the reality of their control is to be found in the banks' strategic plans, due to the fact that *keiretsu* are also shareholders and creditors.

For a long while, this system has induced asymmetric information. The asymmetric approach of game theory — as identified by American economist and 2001 Nobel Prize winner George Akerlof — analyzes how players in a game can optimize their outcomes in either cooperative or non-cooperative circumstances through adverse selection and signaling. This can result in moral hazard problems that are less acute between the different stakeholders, a lower risk of bankruptcy and also a greater ability to focus on decisions aimed at long-term plans.

The negative consequences of the separation of ownership and control functions have been considered ever since the famous analysis by Adolf Berle and Gardiner Means in 1932. At this stage, we must articulate three key ideas: first, the system worked and was virulently attacked by the impacts of deflation which emphasized the level of indebtedness of firms and some exaggerated or excessive investment. Another attack came from a complex form of institutional "fatigue"

CHART 1

Keiretsu of Japanese firms



Source: Chris Halliwell

which is hard to decipher but still does exist. Then, note the strengthening of banks' weight (which can be compared to the shift from *zaibatsu* to *keiretsu*) despite the global context of disintermediation and greater direct access to financial markets in order to fulfill a company's needs.

Specifically, the deterioration of bank balance sheets in the early 1990s led to doubts about the degree of infallibility of the Japanese financial system and its consequences on the financial performance of firms. Between 1990 and 1995, J. K. Kang and R. M. Stulz ("Is Bank-centered Corporate Governance Worth It?", *National Bureau of Economic Research*, No. 6238, 1997) estimated that there was a 26% difference in financial performance for non-leveraged firms in comparison with those presenting usual bank debts.

Regarding capital holding models, everyone understands that hostile takeovers are difficult because of the modes of relationships between the different members of a group and the main bank. This is very different from the easy creation of leveraged buyout or leveraged management buyout operations.

As regards employee relations, the classical model helps to develop a strong attachment to the company and a career logic written in real time. Moreover, banks are precautionary because of employee ownership rights to the assets of the company. Indeed, employees are entitled to full payment of severance pay before any payment of other debts of the company. For fear of losing the principal of their loan, banks prefer to avoid crises and transfer — when possible — some employees from the firm to other companies under its control.

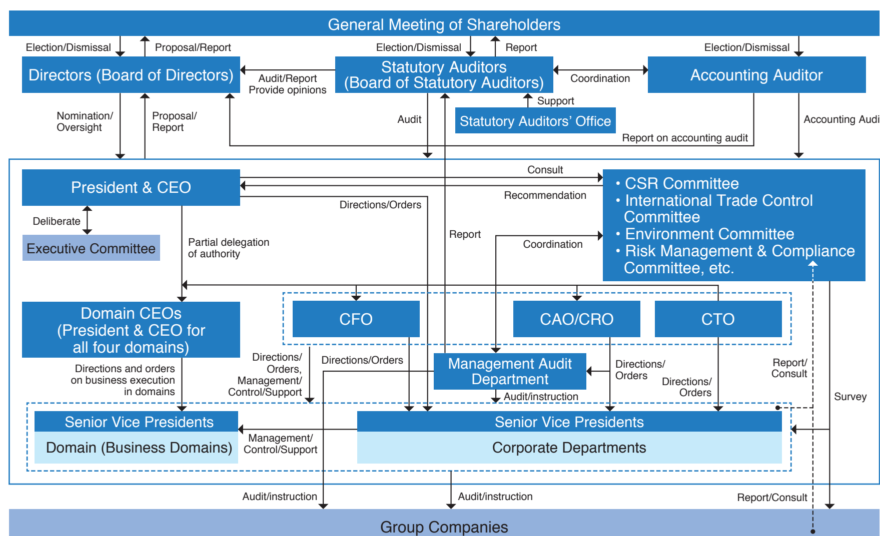
Finally, as in France, one must keep in mind the scale of trade credit, which sometimes reveals a lack of stockholders' equities in enterprises.

No system can pretend to perfection but one has to notice that the previous corporate governance model was widely relevant and deeply rooted in Japanese society itself. We know now that it is time for change but it must be clear that this change will impact a citizen's life. One's overwhelming impression is of a deeper move than usually said. France, the United Kingdom and Germany are here to demonstrate the height of the tide. Corporate governance is not a single set of rules: it deals with power and cash repartition.

CHART 2

New corporate governance structure & roles in Japan

(Including internal control systems) (As of June 26, 2014)



Source: Mitsubishi Annual Report 2014

2. Can the reptilian slough from one system to the other be performed without generating financial and economic inequalities?

The third arrow of Abenomics is dealing with corporate governance. Therefore, it is required to read "Japan's Corporate Governance Code" issued by the Tokyo Stock Exchange (TSE) on June 1, 2015. The goal is clear: "Seeking sustainable corporate growth and increased corporate value over the mid- to long term".

Such a change cannot be made at once: this is why one should have in mind the image of a reptile slough. If Japan wants to succeed as strongly as in the past, it will need time to sew up new types of capitalistic links and improve business practices accordingly.

Normally, the new governance Code should be applied to all companies listed on the TSE and other financial markets such as Jasdaq and the TSE's Mothers. The main purpose of the Code is to build a positive dialogue between shareholders (private or institutional investors) and investee companies in order to reach sustainable growth as well as increased corporate value.

This, from my point of view, can't be achieved in a one-shot strategy. Indeed, it is clear that shareholders are expecting returns on their investment in the form of dividends and are not always eager to think about mid-term corporate value. Some shareholders that can be called faithful are in such a state of mind, but not all of them. "The two wheels of a cart" that are supposed to be firms and investors are not so easy to obtain, especially in a country where corporate governance was not defined by meso-economic (sector-based) factors and was focused on microeconomic variables (profit, dividends). The new Code is a move from the bottom downwards and, if misunderstood, will represent the dawn of a new "partner": the M&A market and deals considered as a "golden key" far from stakeholders concerns.

Therefore, the economic policies advocated by Prime Minister Shinzo Abe ("Japan Revitalization Strategy") need to be explained to citizens, while it also has to be taken into account that the Code is not too prescriptive. Various principles are described in general terms to leave room for proper flexibility. For example, Principle 4.1: "Roles and responsibilities of the Board" states:

The board should view the establishment of corporate goals (business principles, etc.) and the setting of strategic direction as one major aspect of it roles and responsibilities. It should engage in constructive discussion with respect to specific business strategies and business plans, and ensure that major operational decisions are based on the company's strategic direction.

This type of formulation is really appropriate and represents a tangible way of giving time for the overall system to slough, and for each company to shift from an old model to the new one *(Chart 2)*.

3. Will joining the mainstream of Anglo-Saxon capitalism be a boon for Japan?

The new Code is designed on the principles of corporate governance defined by the OECD. Japan has chosen to join the "mainstream" of corporate governance in the United States.

But this private regulation did not prevent accounting malfeasance (Enron and others) and especially the development of off-balance sheet accounting entries that raise questions about the sincerity of book-value delivered to shareholders. Unfortunately this includes recent events concerning Toshiba. No one should forget that the pressure to achieve results (ROI) can generate window-dressing temptations and even accounting fraud.

Historically, it is interesting to note that it was under American influence that Japan decided in 1947 to dismantle its *zaibatsu*. This action was called at the time "the democratization of the securities market". Shall we go as far as thinking that strong US influence has helped the Japanese government in deciding on the third arrow and the birth of the Code? These are open questions for someone living in Europe who has to consider the impact of a future free trade agreement between the US and Europe and its consequences regarding business practices. The big picture, from my point of view, is this: the more one country is close to US business, the more it has to comply *(Chart 3)*.

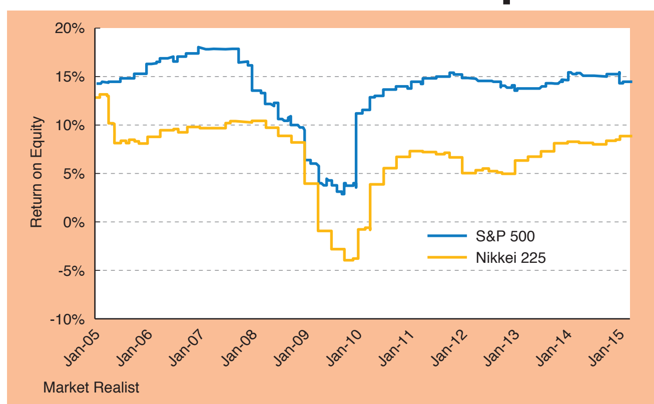
One fact is obvious: Japanese banks will experience a mini-revolution. They have had the role of lender and shareholder, and now they should scale back their working interests, as is the case in Germany, the UK, and the US.

A bank, which is usually less engaged in investment, can be satisfied with minimal control which would enable it to recover the amount of funds lent. It can also attempt to corner a company into bankruptcy if the settlement value is higher than that of the credit granted, especially if the bank's investment section could get a deal with a new buyer. Obviously, it is known that banks would earn more profits by selling a company in difficulty than on recuperated interest by keeping their contracts with that troubled company.

Specifically, the new Code will accentuate the fact that the company can be seen and treated as a commodity, as opposed to the former system in which creditors and shareholders were more supportive. The institutional respect given to the firm will fade before its full immersion in the commercial sphere.

CHART 3

Japanese stocks are less profitable than their American counterparts



Source: NYSE Arca

This will impact on lifetime employment and the quality of the wage system in Japan where the word flexibility will strengthen these positions, to the detriment of companies and at the expense of the accumulated know-how of firms. Excess turnover is not an asset, as shown in the example of some European sectors.

Independent directors among the board should be aware of their financial duties but also of their social responsibilities (Principles 4.8). This will only be possible if Principle 4.12 is strictly applied: "The board should endeavor to foster a climate where free, open and constructive discussions and exchanges of views take place, including the raising of concerns by outside directors." This important principle is linked to compliance and whistleblowing abilities — two subjects that are not, clearly, within the scope of the new Code.

Many companies grow through acquisitions, for redemption of their competitors, and thus neglect the construction, sometimes more patiently, of a profitable conglomerate like Siemens or General Electric. Their top management is more focused on the development of their own business units.

It is feared that new governance in Japan, as in the West, will lead to a stream of takeovers and M&A, some of which will find their deepest explanation in the consistent flattery of shareholders more than in the clever solution of industrial puzzles. The future governance code is ambitious but necessarily hides behind its ambition "a drop" of capitalist greed. To think otherwise would be idle. Moreover, a recent law facilitating M&A proves how the courtyard will be paved.

4. Should Japanese elites succeed in inventing a "policy mix" in corporate governance?

The Code gives the possibility of an important choice: companies are allowed not to apply the Code if they provide a proper explanation ("comply or explain" rule). From what I have read, I think very few will adopt this approach.

Three types of governance will then be possible: a company with a board of *kansayaku* corporate auditors; one with no less than half of its auditors being external but no obligation to have any external directors (*shagai torishimariyaku*); or one with three committees (audit, nominating, and compensation).

With regard to the third choice, the audit committee is given supervisory functions (effective from May 2015) as to the nomination and compensation of directors, including the senior management. In this type of company, a board of *kansayaku* corporate auditors is not requested.

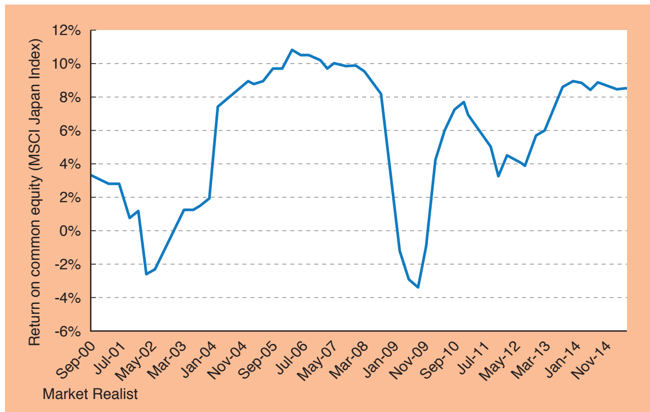
Former French Danone CEO Antoine Riboud used to say in the 1990s: "You can learn everything but instinct." Here, I wonder if the influence of auditors will help Japanese firms to be as daring as in the past.

For 11 years, I have been a legal external auditor. In this capacity, one is focused on compliance matters and due diligence, on accuracy of facts and figures. This has nothing to do with a marketing visionary and commercial sixth sense. Therefore, I am partly skeptical of the first type of governance which seems to be dominant in order to meet transparency obligations. From my point of view, the third choice may be the right path.

At first, it is vital to consider the two-track policy which defines ROI. On the one hand, the board may consider the returns that have to be given back to shareholders. In others words, we speak here of the "bottom line", the benefits after tax that are ready to be converted in

CHART 4

Japanese companies are quite profitable



Source: NYSE Arca

dividends, if decided.

On the other hand, the board may consider ROI as the gross margin plus financial expenses related to each of the projects in process. This view is clearly a way to elaborate a long-term growth. In fact, it leads to respect of the real profitability of a company which is not always the figure that pops up on the bottom-line of the entire company.

Financial ROI Analysis

$$\text{Simple ROI} = \frac{\text{Amount of Financial Gain}}{\text{Total Investment Amount}}$$

$$\text{Discounted ROI} = \frac{\text{Net Present Value of Benefits}}{\text{Total Present Value of Costs}}$$

Which can also be stated:
ROI = (PV Benefits-PV Cost)/PV Cost
("Cost" refers to an investment amount)

Caution should be exercised because an overall ROI is a confusing and excessive technical shortcut. Symmetrically, individualizing the assessment of project profitability can ignore or hide the synergies between these projects. ROI is a quantified result that requires being handled with care, especially as it excludes analysis that comes from "thinking outside the box".

Still it is hard to draw a sharp line between what is usually called ROI and what is bound to happen if the company takes enough time to define the total cost of ownership (TCO), which implies greater accuracy when adding all the ROI constituent elements.

A famous example can be given. With the ROI "theory", Eurotunnel (the firm that operates the tunnel between France and the UK) would have been led into bankruptcy. No dividends, no cost-effectiveness, huge debt. Due to CEO Patrick Ponsolle and others, the firm is now back in the race: profits, dividends, less debt. But more than a decade was necessary to obtain this recovery.

If Japanese firms are led by boards stuck to short-term results and misleading figures, a strategic loss of opportunities and even more will occur *(Chart 4)*. It could turn the *chuuki keiei keikaku* (mid-term business plan) into pieces.

In the meantime, "Japanese companies have had a history of difficult relationships with their shareholders. An ACCA and KPMG Singapore corporate governance report released in November 2014 ranked Japan 21st of 25 countries surveyed." ("Toshiba scandal sheds harsh light on Japan's corporate governance" — *The Guardian*, July 21, 2015).

TABLE 1

Variety of business indicators showing profitability & capital efficiency

Indicator	Formula
Earnings per share	(Net income – Dividends on preferred stock) / (Number of outstanding common shares + Common stock equivalents)
Percentage change in earnings per share	Incremental change in earnings per share / Earnings per share from previous period
Economic value added	(Net investment) × (Actual return on investment – Percentage cost of capital)
Dividend payout ratio	Dividend per share / Earnings per share
Dividend yield ratio	Dividend per share / Market price per share

Source: Riley consulting

In other words, the way of following Principle 5.2 ("Establishing and disclosing business strategy and business plan") will be a key success factor for tomorrow.

When establishing and disclosing business strategies and business plans, companies should articulate their earnings plans and capital policy, and present targets for profitability and capital efficiency. Also, companies should provide explanations that are clear and logical to shareholders with respect to the allocation of management resources and specific measures that will be taken in order to achieve their plans at markets. *(Table 1)*.

Toyota Motor shareholders deserved explanations when the company was presenting plans to issue nearly $4 billion in "Class AA": a new type of stock which behaves like a convertible bond but comes with voting rights.

New steps towards financial engineering are bound to happen and that will not be a contradiction with the new era of increased investor scrutiny.

The new governance will also require a deeper knowledge among directors and *kansayaku* corporate auditors. The world is changing fast and it is obvious that growth-focused companies require highly talented people. Skills may be at the right level but each person responsible must devote enough time and work to fulfilling their roles and duties. Here is another challenge for corporate governance in Japan.

Foreign experiences reveal that top executives are bound to dedicate more time to shareholders and corporate communication ("road-shows") especially if teams coming from the US proxy adviser Institutional Shareholder Services (ISS) — or another example — put pressure on them.

Japan is on a new road to success but it is clear that both stakeholders and shareholders lack readiness in dealing with the real deep changes ahead. The banking system turmoil is a risk as well as the "casino economy" imported by competitors. The Japanese elite will have to create a "policy mix" between the old way and the new path. At its last meeting, the Council of Experts' chair stated: "Japan excels at catching up." Undoubtedly pension funds will appreciate. JS

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