Corporate Governance

BETTER CORPORATE PRACTICES FOR HIGHER GROWTH

- The Japanese economy has for many years been characterised by a low corporate return on equity. Increasing returns requires better corporate governance that improves investment and the use of corporate resources, including cash holdings.

- Measures should include better corporate board practices, the re-examination of cross-shareholdings between companies and more active stewardship by institutional investors.

- Japan has taken a first step by introducing a stewardship code for institutional investors and by developing a national corporate governance code for publicly listed companies.

- Going forward, Japanese authorities, the Tokyo Stock Exchange and the business community need to support effective implementation and widespread use of these codes.

What’s the issue?

Japanese companies show considerably lower profitability than their European and US counterparts (see Figure). This is partly attributed to shortcomings in corporate governance practices and how corporate resources, including cash holdings, are used. In fact, Japanese companies have accumulated retained earnings since 1998. The total amount of retained earnings doubled from 1998 to 2007, and increased to 305 trillion yen in 2012 (64% of the GDP).

There is growing recognition of the importance of the role of institutional investors, both domestic and foreign, to enhance corporate governance practices, as they hold more than 50% of Japanese listed stocks, up from slightly over 30% in 1990. In Japan, the share of foreign investors doubled from 14% to 28% in the last 15 years. This trend has been accompanied by a surge in new types of intermediaries, such as asset management funds and proxy advisors. Listed companies in Japan often hold the shares of other listed companies for reasons related to strengthening of business links rather than purely for investment purposes. This has led to a hollowing out of capital and has been criticised by institutional investors as weakening minority shareholders’ influence. These cross-shareholdings represent another 11% of market capitalisation.

Against this background, the government has recently taken a number of steps to enhance corporate governance. They...

Japanese companies are less profitable than their European and US counterparts

Return on equity and return on sales of Japanese, European and US companies, 2012

Note: Based on actual business results in 2012. All companies in TOPIX 500, S&P 500 and Bloomberg European 500 for which data are available are included in the analysis. Financial and real estate industries are excluded.

Japan has set a target of doubling economic growth from the 1% average of the past 25 years to 2%. To achieve this ambitious objective, the government has launched the third arrow of Abenomics – “a growth strategy that encourages private-sector investment”. One of the ten key reforms in the Japan Revitalisation Strategy is to “enhance corporate governance, aiming at sustainable growth in corporate value”. This should have a positive effect on business investment by prompting companies with high cash holdings to find ways to proactively use their retained earnings for new capital investment.

Corporate governance is also a key determinant of an economy’s competitiveness and growth because it affects access to equity, the allocation of capital and the monitoring of firms’ performance. A better allocation of capital will allow Japan to make better use of its high level of business R&D and human capital. As a result, improvements in corporate governance will stimulate corporate productivity, profitability and competitiveness.

An increased use of independent directors on corporate boards will stimulate corporate creativity, facilitating consideration of independent voices. It will also help to establish a constructive dialogue with investors who are expected to maintain a healthy tension in discussions about long-term corporate value creation and profitability.

Finally, better corporate governance will promote firm creation, which is low in Japan. Indeed, the business start-up and closure rates in Japan averaged only 4.5% over 2004-09, compared to 10% in the United States and the United Kingdom. As a result, Japan’s SME sector is dominated by old firms; three-quarters are more than ten years old compared to a share of less than half in most OECD countries.