Foreign Investors Who Became the Largest Stockholders, and Corporate Governance Reform in Japan

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The stockholding of Japanese listed companies by foreign investors reached 30.8% at the end of 2014. This figure surpassed the holding ratio of 26.7% by domestic financial institutions, which used to be at the top in terms of holding ratios. Foreign investors became the largest stockholders in the Japan Corporation for the first time in history, replacing Japanese financial institutions that had had an overwhelming influence on corporate management through lending and stockholding under the main bank system. The governance reform of Japanese companies, long discussed, is entering a new phase along with the growing trend of foreign investors, many of whom are "self-assertive stockholders."

Enhancement of Corporate Governance Emphasized in Japan Revitalization Strategy

The Abe administration approved the Japan Revitalization Strategy 2014 at a Cabinet meeting in June 2014. This strategy stresses that "it is essential for global corporations in particular to strengthen corporate governance with a focus on capital costs, and to realize the sustainable development of corporate value in order to expand corporate profits through improved productivity and reallocate them to wage increases, reinvestments and returns to stockholders.”

This strategy is based on the expectation that companies, which are the main actors in economic activities, will steadfastly build up their earning power, expand employment, raise international competitiveness and work appropriately to fortify the growth potential of the entire Japanese economy. Currently, fewer than 40% of the listed companies are able to achieve profits and pay corporate income tax. Even quite a few profitable companies secure profits by reducing wage costs through employment cuts and peddling assets instead of pushing proactive management, such as developing new products and services and tapping new markets.

As long as this situation remains unchanged, only around half of government expenditure will continue to be covered by tax revenue, and neither fiscal reconstruction nor Japan’s economic recovery will be realized. The Abe administration’s economic policy, called Abenomics, will soon be in its third year. Until recently, the stock market rose amidst growing anticipation of the policy. However, this has not led to the revitalization of the real economy, such as corporate management behavior. Of Abenomics’ “three-arrow” policies, the first arrow of a different-dimension loose monetary policy and the second arrow of flexible fiscal policy raised public expectations, but their effects were merely reflected in the increase of stock prices.

Although both loose monetary policy and expansive fiscal policy can work as economic stimulus measures, they cannot facilitate proactive corporate management or the greater growth potential of the entire Japanese economy. The attitude of risk-taking corporate management is essential to raise potential growth rates, that is, the ability to achieve sustainable economic growth rather than cyclical economic push-ups. Fundamental structural and institutional reforms, including regulation reform, are indispensable for realizing these factors. This is exactly what the third arrow of Abenomics seeks to do.

The Japan Revitalization Strategy 2014, which is around 120 pages long, uses the word “innovation” repeatedly, as many as forty times. The word “productivity” is also repeated more than thirty times. In addition, the phrases “corporate value creation,” “earning power” and “metabolism” are used throughout the document. However, all of these things can be realized only once the third arrow of structural reforms is implemented surely and steadily. No matter how hard the government implements a drastic loose monetary policy and expands fiscal spending, those things cannot be achieved. It is for this very reason that the government emphasizes the strengthening of corporate governance.

IMF’s Warning and an Increase in “Self-Assertive” Foreign Stockholders

The International Monetary Fund (IMF) proposed that Japan strengthen corporate governance in its August 2014 Working Paper “Unstash the Cash! Corporate Governance Reform in Japan.” This Working Paper notes that Japanese companies have more cash and cash equivalent holdings than necessary, and that they are inactive in utilizing money for capital investment and research and development. The ratio of Japanese companies’ cash and cash equivalent holdings to market capitalization is almost 45%, which is remarkably high compared with the 15% to 27% ratios of G7 nations other than Japan. The paper presents a view that the gaps in corporate governance are reflected in these figures.

What should now be noted in relation to corporate governance is how foreign investors, who have become the largest stockholders in Japanese companies, will call on their investee Japanese firms for corporate governance reform.

The stockholding structure of Japanese listed companies changed dramatically following the financial crisis of 1997. The holding rate of institutional investors increased from 28% before the crisis to 48% in 2013. In particular, the holding rate of foreign institutional investors went above 30%, as noted above, and the impact of these foreign stockholders on their investee Japanese companies' management is attracting a great deal of attention. That is, the point is whether or not Japanese corporate governance will be strengthened to facilitate the shift from inactive to proactive management through foreign pressure, and to realize the development of corporate value.

Recently, twenty groups of foreign institutional investors, including the California Public Employees' Retirement System (CalPERS), known as "self-assertive stockholders," sent letters to thirty-three Japanese listed companies, including Toyota Motor Corporation, NTT Docomo, Inc., Sumitomo Realty & Development Co., Ltd. and Mitsubishi UFJ Financial Group, Inc., calling for an increase in outside directors. The letters called for the Japanese listed companies to raise the percentage of highly independent outside directors to more than one-third within three years. In addition, the letters stated that if the Japanese companies failed to achieve this goal, the foreign institutional investors would address the issue at the stockholders' meetings in seven years' time.

In Japan, direct investments involving direct corporate management are slow to increase, but foreign investors are extremely active in the stock market. In 2013, foreign investors recorded net buying of as much as 15 trillion yen worth of Japanese stocks in great anticipation of Abenomics. This presents a striking contrast to the net selling from Japanese individual and corporate investors. That is, the Japanese stock market under Abenomics was primarily supported by foreign investors. This means that the percentage of foreign investors in the stockholding structure increased further under the initiative of Abenomics.

The abovementioned thirty-three Japanese listed companies that received letters from CalPERS regarding the strengthening of corporate governance are all high in terms of market capitalization and low in terms of the ratio of outside directors. In the case of Toyota, for example, of its fifteen directors, only three are outside directors. In the West, in contrast, companies with an outside directors' ratio of more than 50% make up over 90% of all companies.

As of the end of March 2014, the foreign stockholding ratio of Toyota reached its highest level ever of 30.3%, a 0.4% increase from the previous year. Hitachi, Ltd. also showed a 4% increase, at 45.4%, which was the highest foreign holding ratio it had ever recorded. During the same period of time, around 2,300 companies, or two-thirds of all Japanese listed companies, showed an increase in this ratio.

Companies that showed record high foreign holding ratios as of the end of March 2014 included Kao Corporation (50.7%), Shiseido Co., Ltd. (35.5%), Dentsu, Inc. (27.9%), Seiko Epson Corp. (25.7%), Seven & i Holdings Co., Ltd. (35.0%), KDDI Corporation (38.0%), Panasonic Corporation (33.2%) and Ryohin Keikaku Co., Ltd. (47.9%).

It is becoming a point of interest, both in Japan and overseas, as to how much these foreign investors with an increasing holding ratio of Japanese listed companies, particularly foreign institutional investors such as CalPERS, will function as "foreign pressure" or a catalyst for changing Japanese corporate governance.

Governance Reform Launched from Within the Country

We can see the domestic progress of slow but active discussions about corporate governance reform emphasized by the Japan Revitalization Strategy 2014. The discussions were triggered by the reaction from domestic and foreign investors in the aftermath of the Lehman shock in 2008. They noted the lower profitability of Japanese companies compared with that of foreign companies amidst the delayed performance recovery of Japanese companies, and expressed growing dissatisfaction with the prolonged sluggishness of stock prices. Those investors presented the observation that one of the factors for the low profitability of Japanese companies was the lack of adequate corporate governance.

Corporate governance reforms include the motion of calling for institutional investors, such as investment advisory companies that are commissioned to manage funds by their clients, to fulfill their fundamental roles and functions, and the motion of directly transforming companies themselves through the revision of the Companies Act.

The former motion of focusing on the responsibilities of institutional investors began to progress when the Financial Services Agency published the Japanese version of the Stewardship Code (the Principles for Responsible Institutional Investors) in February 2014.

The steward is an asset manager and the Stewardship Code, which originated in Great Britain, is a code of behavior for institutional investors that hold corporate stocks. Triggered by the financial crisis of 2008, based on the recognition that one cause of the crisis was the fact that banks had neglected to fulfill their responsibility to appropriately oversee the boards of directors of their investee companies as institutional investors, the British government formulated the Stewardship Code in 2010. This code is intended to encourage stockholders, corporate executives and other stakeholders to exert an influence over the operational processes of management so that companies can raise long-term sustainable performance.

The Japanese corporate governance theory was initially focused on compliance to prevent corporate scandals. However, the Japan Revitalization Strategy in the context of Abenomics is focused on restoring the resilience of the Japanese economy through the revitalization of businesses.

The Japanese version of the Stewardship Code formulated by the Financial Services

Agency is also in line with this strategy.

The Financial Services Agency's code is made up of the following seven principles.

The Principles of the Code

1. Institutional investors should have a clear policy on how they fulfill their stewardship responsibilities, and publicly disclose it.

2. Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.

3. Institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the sustainable growth of the companies.

4. Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.

5. Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.

6. Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.

7. To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

These codes are not legally binding rules, but rather principles and gentlemen's agreements.

By the end of August 2014, however, 160 institutional investors, including 109 investment trust management companies and investment advisory companies, 17 pension funds and 16 trust banks, had already announced that they would accept the code.

Japanese corporate management often involves a culture of “non-self-assertive” stockholders. Companies have lifelong employment and seniority-based promotion systems. The president is internally promoted to the position. The president has a strong personnel authority and the board of directors’ meetings are frequently not an arena for discussion but a forum for a ceremony of “non-self-assertion.” Many employees hold the stocks of their companies. The ratio of cross-holdings among closely related companies is also high. In addition, around 80% of Japanese listed companies hold regular stockholders’ meetings every June, and more than 90% of those meetings are concentrated in late June. In this situation, stockholders’ meetings are mere formalities, and in fact there are few active discussions about how to improve corporate value.

Even under this stockholding structure and stockholders’ meetings, many corporate managers actively took risks and raised their corporate value during the postwar period of rapid economic growth. However, after the bursting of the bubble economy in 1991, and particularly the collapse of Sanyo Securities Co., Ltd. in November 1997, the financial crisis worsened in 1998. Amidst this situation, many corporate managers shifted to a passive attitude and rapidly leaned toward not taking any risks. This trend was triggered by the emergence of financial institutions engulfed in the crisis of non-performing loans and the collapse of their governance, although those institutions used to direct corporate governance under the main bank system.

Amidst the financial crisis, financial institutions were reluctant to lend, and even retracted loan credit from their client companies. On the threshold of 1998, the balance of loans from private sector financial institutions decreased dramatically, which led to a typical credit crunch. With a deeper sense of crisis, companies prioritized cost reductions called “restructures,” such as personnel cost cuts, and lost their willingness to make capital investment and research and development investment. Although the issue of non-performing loans has already been resolved, financial institutions are still unwilling to lend, and the Bank of Japan's ultra-loose monetary policy does not lead to active lending from financial institutions. Companies are still suffering from the lingering effect of the traumatic experience of having loan credit forcibly retracted by banks when the abovementioned financial crisis hit. There is still the issue of excessive internal reserves, which the IMF recommended in its Working Paper that Japanese companies should tackle.

It is necessary to overcome the "deflation in the corporate manager's mind" in order to resolve deflation. This is a significant future challenge in carrying out corporate governance reforms.

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