Pension fund management

The Diverse Evolution of Traditional Corporate Boards in Japan

By Keisuke Nitta
nitta@nli-research.co.jp

After Sony introduced a new executive officer system in 1997, Japanese corporate boards began evolving at a rapid pace. We overview the recent transformation of management structures, and examine the expectations gap between pension funds and corporate boards regarding the role of outside directors in corporate governance.

Ever since Sony introduced a new system of executive officers (*shikko-yakuin seido*) in 1997, the structure of corporate boards in Japan has been evolving rapidly. The typical or traditional board structure of Corporate Japan, which became widespread in the rapid economic growth era, is already in the minority. Most corporations today have implemented board reforms such as the introduction of executive officers to redistribute decision-making powers, reduction of board size, and increase in the ratio of outside directors.

Meanwhile, improvements have also occurred in the legal infrastructure, including the amendment of the Anti-Monopoly Law to allow the establishment of holding companies. Of particular interest is a new provision in the Commercial Code revision of 2002 that allows companies to set up a board committee system. This has expanded the structuring options available to Japanese corporations beyond the traditional management system to those resembling a U.S.-type system.

In the past, typical corporate boards in Japan were characterized by: (1) a large number of board members, (2) non-separation of monitoring and operating functions, and (3) prevalence of inside directors. Starting in fiscal 1996—one year before Sony's reform—we extracted 639 corporations (excluding financial corporations) listed on the Tokyo Stock Exchange First Section that exhibited these traditional characteristics, and tracked their progress in board reform. We found that substantial progress has occurred; as of the end of fiscal 2004, only 174 firms (29.9% of the total) had yet to implement a significant reform (Exhibit 1).

Exhibit 1 Progress and Pattern of Corporate Board Reforms

(No. of companies)

Fiscal year	Total	① Introduced new system	② Reduced board size	③ Increased % of outsiders	① and ②	② and ③	③ and ①	①, ② and ③	No reform
1997	639	1	4	7	1	1	1	1	629
1998	635	11	24	20	6	4	1	1	590
1999	634	80	113	33	70	14	6	6	492
2000	630	145	183	60	123	42	34	31	410
2001	622	202	240	73	176	54	46	44	339
2002	605	249	288	92	223	75	72	70	276
2003	589	311	339	114	285	97	93	90	210
2004	581	350	370	128	322	117	109	107	174

Notes: Covers companies that as of fiscal 1996 had at least 15 board members, of whom less than 30% were outside directors (but not from banks or controlling firms). System reform refers to introduction of an executive officer system or shift to a board committee system. Board reduction is counted if the number of members has decreased at least 30% from fiscal 1996. Increase in ratio of outside directors is counted if the ratio has increased at least 10% since fiscal 1996.

Source: Miyajima and Nitta (2007), "Diverse Evolution of the Traditional Board of Directors: Its Causes and Effects on Performance," in *Corporate Governance—Diversification and Prospects*, Kinzai (in Japanese).

As a result of widespread board reforms, the average number of board members at TSE First Section corporations (including non-financial corporations not in our survey sample above) plunged from 17.65 members in fiscal 1996, to 10.37 members in fiscal 2004. Meanwhile, corporations with at least 30% of directors from outside the company (not from banks or controlling firms) surged from 122 corporations (10.7%) to 293 corporations (19.6%).

Next, we examined correlations between the three components of reform: (1) introduction of an executive officer system or board committees system (noted below as system reform), (2) reduction of board size, and (3) increase in the ratio of outside directors. Two patterns emerge among corporations that have implemented reforms—they implement system reform combined with board size reduction, or else adopt all three components. As for the timing of reforms, we found that corporations do not address all components simultaneously, but instead introduce reforms gradually over time.

We performed a quantitative analysis of active and passive factors driving the three reform components. Regarding board size reduction, a key active factor appears to be the goal of reducing internal coordination costs. The increase in ratio of outside directors is apparently driven by an active factor—the aim of expanding their advisory role—and a passive factor in the form of market pressures. System reform also contains a mix of active and passive factors.

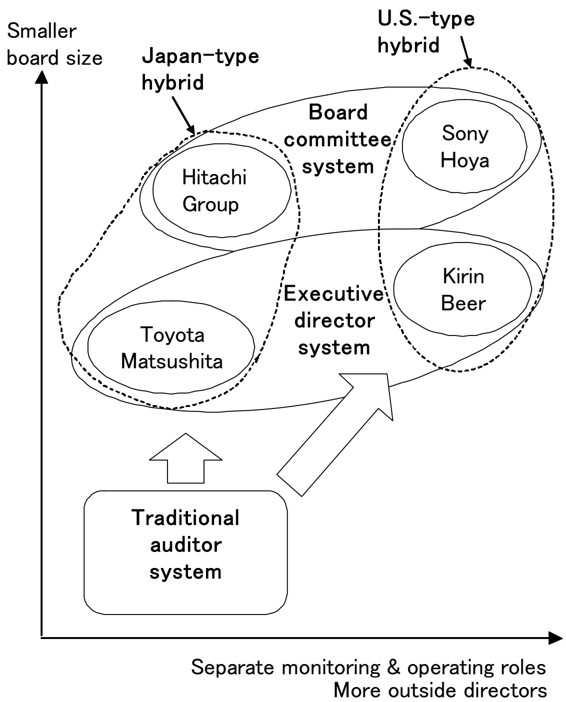
As for performance effects, our quantitative analysis indicates that ROA performance is affected mostly by board size reduction and increase in ratio of outside directors; system reform by itself appears to have no significant performance effect. This implies that to successfully contribute to performance, structural reforms must sufficiently reduce the number of directors or increase the ratio of outside directors.

Overall, our results suggest that the traditional management structure is not simply converging toward a U.S.-type structure, but differentiating into two types—a U.S.-type hybrid resembling the management structure of the U.S., and a Japan-type hybrid that modifies the traditional structure (Exhibit 2). Moreover, corporations appear to be adopting management structures that are consistent with their business environment and internal characteristics.

While both hybrids aim to streamline the board of directors and improve the efficiency of decision making, they differ sharply in the role expected of outside directors. At U.S.-type hybrid corporations, monitoring and operating functions are clearly separated, and outside directors are primarily devoted to monitoring. In contrast, at Japan-type hybrid corporations, where monitoring and operating functions are fused together, the main role of outside directors is to work with internally promoted managers by providing advice that augments their limited perspective.

At the present stage of evolution, most Japanese corporations are Japan-type hybrids, where outside directors are expected to serve as advisors. Meanwhile, institutional investors expect outside directors to perform a monitoring role. Clearly, to overcome this expectations gap and improve mutual understanding, the first step is to recognize the gap's existence.

Exhibit 2 Evolution of Corporate Boards



Source: Miyajima and Nitta (2007)