

# **Effective Implementation of Corporate Governance Principles and Promotion of Finance for Growth Companies in Japan**

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OECD Asian Roundtable on Corporate Governance  
24 October 2016 in Seoul, Korea

It is a great honour and pleasure to make a presentation to such great colleagues and distinguished guests. First, I'd like to express my appreciation to the Korean Government for the wonderful hospitality and the OECD Secretariat for the excellent arrangements.

Today, I would like to talk about two things.

The first and main topic is an update on corporate governance reform in Japan, including the implementation status, new challenges and its contribution to economic growth. The second topic is the financing situation of growth companies and SMEs, and IPO trends.

Let me start with the update on Corporate Governance Reform in Japan. Our key instruments of CG reform are the Stewardship Code for institutional investors and the CG code for invested companies. They are “two wheels of a cart”. Both of them work together to support the sustainable growth of companies, creating a virtuous cycle.

Regarding their implementation status, first, 213 institutional investors, covering almost all major investors in Japan, have already accepted the Stewardship Code. And these investors have complied with around 90% of the Code's principles.

Next, on the CG code. Over 80% of 2262 listed companies comply with over 90% of the principles contained in the CG Code, and when they do not meet any of the principles many of the companies have publicly explained why not.

As for principles with a relatively high rate of explanation, the non-compliance ratios for “Board evaluation and disclosure of summary” and “Two or more independent directors” have significantly improved. This good development exceeds our expectations.

Around 80% of the TSE First Section listed companies now have more than two independent directors, a more than 30% increase from the last year and a big jump from around 10% only six years ago.

Japan's three major banking groups have unveiled their plans to unwind cross-shareholdings by around 30% within 3 to 5 years. This unwinding is steadily progressing, and other sectors have also started to follow suit.

Now we focus just a bit on CG reform of growth companies.

The Mothers market offers a trading market for companies with growth potential which aim to be reassigned to the First Section, in which leading companies are traded in the near future. Thus, TSE requires applicants to demonstrate high growth potential. JASDAQ is also a section for growth companies.

Among the companies listed in Mothers, the number of companies that have accepted the CG code doubled from December 2015 to July 2016. This is because TSE made it an obligation to basically accept the CG code. This result suggests that small but growing companies are also keen to keep up with CG reform.

Companies listed in Mothers and JASDAQ are required to “explain” only about any of five general principles that they decide not to comply with, while companies listed in the 1st and 2nd section are required to explain about any of the total of 73 principles that they decide not to comply with. Looking at the codes of UK, Germany and France, they don’t require an explanation in the markets for new companies. On the other hand, it would be more desirable for the concept of “explanation” to somehow become familiar with growing companies. Therefore, we decided to ask the growing companies to explain only general principles.

On the appointment of independent directors in each section. not only in the 1st and 2nd sections, but also in the Mothers and JASDAQ sections, increasing companies are appointing independent directors. For instance, companies with two or more independent directors in Mothers increased by 17%.

Now let’s move on to new challenges facing CG reform

First, we have to deal with technological innovation in the financial market from the CG perspective. Indeed, the revised G20/OECD Corporate Governance Principles capture recent developments of stock markets and exchanges, which stipulate that while the quality of and access to market information including fair and efficient price discovery regarding investment is important for shareholders to exercise their rights, most of the large stock exchanges now maximize profit in competition with other exchanges. It then becomes more difficult for exchanges to exercise self-regulatory functions to enhance the integrity, transparency and stability of the markets. In this context, it is necessary to analyze how particular business models of stock exchanges affect the incentives and ability to carry out these functions.

In accordance with the Principles’ point of view, Japan launched the official study group to discuss these issues, including the impact of recent IT innovation such as the significant increase in algorithmic trading. When completed, we would like to share the necessary steps and measures to establish a financial market which contributes to effective CG.

IT development is significant. Since TSE launched its co-location service in January 2010, the share of algorithmic orders has been increased, accounting for nearly 70% of total orders.

This leads to some risks. For example, the fast and automated operation of algorithms may impair the stability and resilience of the market by increasing transitory volatility and abrupt movement. Also, price discovery functions of the market focusing on the long-term performance of the company may be hampered, when algorithmic trading occupies the majority of the trades.

But what about the economic results of these efforts?

Although we have the various remaining challenges I have just mentioned, our CG reform has greatly contributed to economic revitalization, though it is difficult to quantify.

First, the amount of cash dividend and stock repurchase has increased to a record high. Also, the ROE of Japanese companies has improved by 2.4 p.p. since Abenomics was launched

Second, the tight labor market condition is reflected in an increase in wages. Last year, the increase rate marked the highest since the end of the bubble economy and has stayed at a high level.

Third, corporate earnings hit a record high and the growth has been positive for almost three years. While this positive aspect has yet to boost capital investment. Retained earnings continue to rise and so do companies' cash deposits, which we are not satisfied with. Overall, our CG reforms have made significant progress but there is still some way to go.

Next, I would like to touch upon the financing situation of growth companies in Japan.

The investments to venture businesses in 2015 have increased by 11.2 % to 130 billion yen and the number of investments has increased by 19.9 % to 1,162. The amount invested is recovering after bottoming out in 2009, but has not recovered to the levels as high as around 280 billion seen before then.

The international comparison of business entry rate, percentage of entrepreneurs and VC investment to GDP shows Japan recorded low levels for all three factors.

To improve such situation around venture businesses, we formulated "Venture Challenge 2020" in April 2016 to create a Japanese venture eco-system by integrating various support measures and all participants, including the government, firms, and universities. Also, we set a new target to double VC's investment to VBs by 2022.

Let's move on to the broader category of SMEs. This topic about all SMEs, including mature companies, not just growth companies. More than 80% of the companies with bank

financing say their main financing source is “borrowing from the bank,” followed by “retained earnings.” On the other hand, companies with no bank financing answer “retained earnings” is their main source. Only very few companies chose equity as their financing tools. SME’s demand for equity remains quite low and their major financing tool is still bank lending.

Although their major demand is bank lending, bank lending to SMEs decreased and has not recovered yet while lending to big firms is rapidly increasing.

Therefore, SMEs must have some difficulties with financing their needs.

Recently we have been encouraging financial institutions to actively contribute to the revitalization of the economy. Since the bubble economy burst, regulators tend to evaluate the soundness of financial institutions mainly through individual asset assessment through onsite monitoring. Consequently, banks have tended to depend on financial data, collateral and guarantee. Now, we encourage banks to underwrite loans relying on customers’ future business prospects, not just on collateral and guarantee.

Lastly, I would like to briefly explain Japanese IPO trends.

The number of firms going public drastically decreased until 2009 and has been gradually recovering since 2010, but has not reached the level seen before the Lehman Shock Crisis yet.

The number of firms and amount financed are also increasing, although a surge in 2015 is partly from the giant IPO of Japan Post. On the other hand, the ratio of initial offering price to the average offering price is decreasing. In 2013, against the backdrop to increasing attention to IPO stocks, the ratio was as high as 2.5 in Mothers and only one firm recorded an initial offering price lower than the offer price. This ratio decreased in 2014 and 2015, and it is likely to continue to do so in 2016. In 2014, some IPO firms recorded a lower-than-expected performance after IPO. Some of them even revised their prospect downwards right after their IPO. This seems to have influenced investor sentiment and decreased the ratio. This situation has strengthened public requests for implementing CG for growth companies.

Tokyo Stock Exchange, therefore, published its changes in measures against inappropriate transactions by owners in newly listed companies and considerable changes of prospects after they introduce counter measures such as strengthening their examination before IPO and requiring appropriate disclosures of prospects with ample evidence and condition.

To conclude, we have made significant progress in the CG reform, however, many issues remain to be sorted out or are newly emerging. Corporate Governance has no goal but is an evolving process for the better. And this applies to growth companies as well.

Thank you.