Developing high-performing boards in Japanese companies

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Japanese companies need a fundamental mindset shift to create "high-performing boards." Boards should work as equals with the executive team, focusing on stewardship rather than just monitoring. To make this happen, independent outside directors should lead the board, serving as chairs, lead independent directors, and committee heads. They should also objectively evaluate the board's effectiveness in meeting stakeholder expectations and work to address any shortcomings.

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Following the Tokyo Stock Exchange's 2023 directive on corporate governance, a wave of change has swept the Japanese market, with stock prices surpassing bubble-era highs. Boards of directors are at the helm of this corporate transformation.

For Japanese companies to create and maintain "high-performing boards" that generate long-term value, they must move away from merely responding to external pressures for ideal governance formalities. Instead, they should proactively recognise the significance of change and move forward with purpose.

Until now, my work has focused on supporting the nomination and compensation areas of board functions. As a contentious issue, with the common understanding that no one trusts self-assessment, executive nomination and compensation have been at the forefront of governance reform. Companies have made slow progress over years.

As a result, this theme has led the way in establishing boundaries between supervision and execution within the traditional Japanese board model. However, the process has often been perceived as an "invasion by independent outside directors and defense by the top executives" by those involved, creating an adversarial dynamic.

If companies proceed with overall board reforms half-heartedly, simply to comply with external pressures, there may be a mismatch between stakeholder expectations and the reality of a high-performing board.

In this article, I outline my personal thoughts on where a drastic shift in corporate mindset and reexamination is necessary for the implementation of high-performing boards.

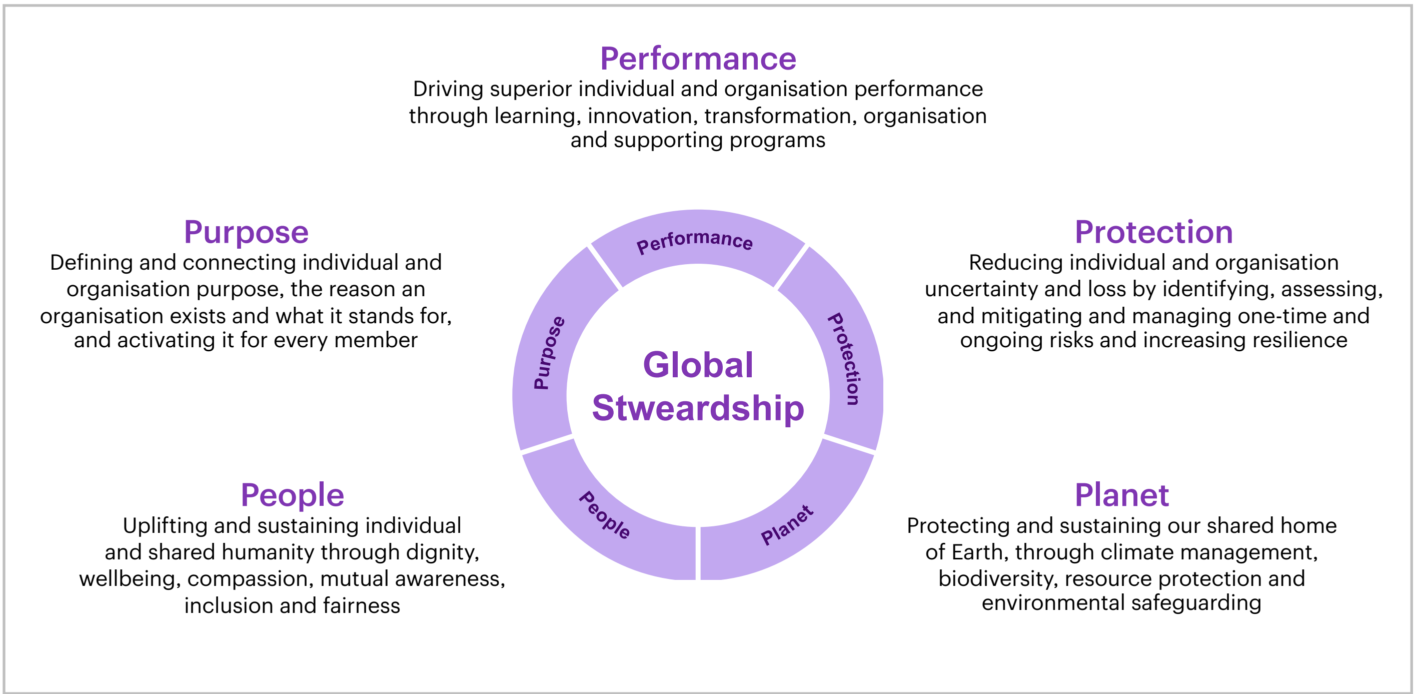
Clarifying the board's role based on stewardship responsibilities

First, the board's role is often not well defined, leading to an inconsistent understanding among individual directors about their responsibilities. Many Japanese companies aim to increase the number and proportion of outside directors as the end goal of board reforms, essentially moving toward a monitoring board model. However, the high-performing board expected by stakeholders goes beyond mere supervision.

In today's era of rapid technological advancements, climate change, pandemics and geopolitical turmoil — an era of prolonged change and uncertainty — boards are expected to motivate employees, harmonise with the global environment and communities, and deliver high returns on capital to shareholders. Individual directors must make prompt decisions considering complex and fluid elements, without relying on past experiences that may be dramatically different from the current environment.

At WTW, our Global Stewardship Model defines the responsibilities of today's boards in terms of five elements: Purpose, Planet, People, Performance and Protection (Figure 1).

Figure 1: **WTW Global Stewardship Model**



The underlying premise is that the board should fulfill its duties based on its own intrinsic will as the steward of all stakeholder capital, including shareholder capital. The relationship between the board and the management team should be one of mutual collaboration and solidarity, with the fulfilment of stewardship relationship as the ultimate purpose.

In this model, performance, including the supervision of management, is positioned as only one element under stewardship.

If fulfilling stewardship responsibilities is the expected role of the board, then the vague notion of strengthening supervision could lead individual directors to misunderstand their roles. In fact, some directors seem to be under the misconception that their job is to comment on the execution-oriented agendas raised by the management and act in a supervisory role, without questioning the appropriateness of the agendas themselves. Particularly for outside independent directors, there is a tendency to be reticent about raising new agendas beyond the scope to avoid being seen as a nuisance by the management team. The adversarial relationship as a stringent supervisor and the accompanying reticence toward management seems to be creating a psychological hurdle to fulfilling their intended roles.

In contrast, disclosures from Western companies provide surprisingly detailed descriptions of the board's role, the scope of their involvement and records of their activities for the fiscal year, including processes and substance of deliberations. Many Japanese companies merely disclose that the board's role is supervisory, without necessarily clarifying how the board has been involved in major themes, even if they disclose their corporate initiatives.

For Japanese companies to proactively proceed with the implementation of high-performing boards, it is necessary to have clarity around the roles that individual directors should fulfill. To do so, it is essential to specify in advance the shared understanding of the board's roles and themes for deliberation, based on stewardship responsibilities as the guiding principle. It is also important to include themes that are priorities for Japanese companies, such as business portfolio management and global management for enhancing capital profitability.

Additionally, companies should establish a cycle of meticulously disclosing the board's activity status each period, detailing what was deliberated and what decisions were made for each theme. The awareness of external disclosure practices can significantly enhance the commitment level of individual directors. For themes deliberated in committees, it may also be useful to incorporate the practice of issuing committee chair messages in the disclosure. These are common disclosure practices among Western companies.

Along with this, the relationship between the board and the management team should be reexamined not as an adversarial relationship evoked by the word "monitoring" but as an equal relationship where they share the complementary functions of stewardship and execution. For each party to fully fulfill its role, the board should focus on long-term stewardship responsibilities toward stakeholders, without getting involved in day-to-day operations. Meanwhile, the executive management team should focus on exercising strong leadership and swiftly and forcefully driving strategies. In other words, it is important that the board and management teams are aware of the importance of effectively utilising each other.

With regards to the legal board structures in Japan, it's best to first clarify the board's roles, as mentioned

above, and then look at the optimal structure for its operation from that perspective. Steps to develop an optimal structure should not precede the examination of the board's roles. However, from the standpoint of global consistency and agility in decision making, one-board structure with three statutory committees (nomination, compensation and audit committee) undoubtedly have a distinct advantage.

Board composition led by a team of independent outside directors

If a board fulfilling stewardship responsibilities is considered a high-performing board, what would an effective board composition look like?

The fundamental element needed for a board to secure the collective interests of various stakeholders is diversity. However, it is not merely about assembling diversity in gender, nationality, race and age or diversity in skills and experiences. More importantly, achieving cognitive diversity is crucial. In an environment of complexity and rapid change, diversified perspectives in the boardroom are an essential requirement for comprehensively examining those issues from all angles, identifying risks, generating innovation, breaking free from fixed notions and boldly advancing necessary changes.

Then, what is behind the public's strong demand for a high composition of independent outside directors? If fulfilling stewardship responsibilities is the board's role, presumably there should be no issue with an insider-led board, as long as diversity is secured? Inside directors may be more suitable for exploring new opportunities through business operations, given their familiarity with the company's business. If outside knowledge or ideas are needed, external experts could be hired. For occasions where independence is essential, such as for nomination and compensation, committees could be utilised to enhance independence, effectively delegating objective decision-making authority. If the public opinion is calling for further increases in the number of independent outside directors solely from strengthening oversight, it is not surprising that companies are somewhat reluctant to accept.

However, here is another point that requires second thoughts. The public demand for a high proportion of independent outside directors should be viewed as helping to create an open and flat discussion forum for constructive and equal deliberations, rather than merely strengthening monitoring. With more outside directors, there would be less hierarchy or camaraderie that may be brought in by inside. Even a slight sense of hierarchy would psychologically inhibit the expression of opinions that do not align with those of superiors, and this tendency would be even more pronounced in the relationship between the evaluators and those being evaluated. An overly strong sense of camaraderie can also foster an atmosphere of avoiding conflicts, leading to self-restraint even when opposing views exist.

The more inside directors there are, the more pervasive this atmosphere becomes throughout the board, increasing the risk of groupthink in decision making.

Even if the skill matrix appears diverse on paper, it is meaningless if differing perspectives and ways of viewing issues do not actually surface in the discussions. To enable individual directors to actively express their skills, experiences and values, it is desirable for independent outside directors, unencumbered by relationships within the company's executive team, to hold a majority on the board.

To further stabilise the creation of an open and flat discussion forum, it is beneficial for the board to be led by a team of independent outside directors. As such a team is formed, the chair of the board, as well as the chairs of committees overseeing key themes for the board, should also be an independent outside director. Additionally, it's also important to appoint a lead independent outside director to support the board chair. This position might help to facilitate coordination between the board and various committees as well as the management team and lead the evaluation of the board chair. The board secretariat supporting the team should also be structured to directly support the independent outside director team. Such a team formation is considered essential for establishing the board as an autonomous body that fulfills stewardship responsibilities and builds an equal and sound relationship, as well as a good collaborative relationship, with the executive management team.

Deepening board effectiveness assessment based on stakeholders' expected roles

Currently, with the exception of a few leading companies, the board effectiveness evaluations conducted by Japanese companies have largely become a formality to comply with Japanese Corporate Governance code. The in-house secretariat administers a questionnaire, almost pleading with the board, and while extracting some sense of issues from the results obtained, many companies ultimately disclose that "the company's board has been confirmed to function effectively overall" and leave it at that. In recent interviews WTW conducted with institutional investors and others, the predominant view was that the current board effectiveness assessment by Japanese companies, centered on self-evaluations, lack objectivity and credibility. Even before considering the use of third-party external assessor, there seems to be a lack of internal discipline in the act of conducting evaluations. However, if the board evolves into an autonomous body led by a majority of independent outside directors, with stewardship responsibilities as its guiding principle, the effectiveness evaluation can aim higher. By having the board chair, lead independent director and committee chairs take the lead in the process while maintaining checks and balances, the evaluation can break away from the image of a self-indulgent self-evaluation.

Here are some steps Japanese companies can take to undertake more effective evaluations going forward:

First, the definition of board effectiveness should be reexamined from the perspective of whether the board is fulfilling the roles expected by stakeholders. Instead of searching for findings solely from the current board member's perceptions, the board should proactively listen to external voices and gather feedback directly from stakeholders, including shareholders and employees, as well as global trends on the roles expected of board.

The board should then objectively identify gaps, including the appropriateness of the roles themselves, and formulate action plans to bridge those gaps. At Western companies, it is standard for the board to lead engagement dialogues with major stakeholders. Discussions related to the board's expected roles are typically led by the chair, lead independent director and committee chairs, who directly receive feedback. The content of the dialogues and action plans are disclosed in detail. Japanese companies are also being requested by the Tokyo Stock Exchange to disclose the status of dialogue with shareholders.

Leveraging this opportunity, in addition to self-evaluations through questionnaires and interviews, companies should introduce a process where the board directly listens to the voices of stakeholders in an effort to identify gaps. By doing so, the board can objectively maintain and manage its effectiveness as a high-performing board.

Managing diversity will likely be key to enhancing effectiveness. The more diversity the board has, the more difficult it becomes to share a common understanding as a basis for decision making. Possible measures include using like dashboards to comprehensively and systematically organise the information necessary for effective board discussions, However, overseas, the importance of establishing a “board culture” has been highlighted in recent years. For example, in the 2023 report “Culture as the Foundation: Building a High-Performance Board” published by a Blue-Ribbon committee of the National Association of Corporate Directors in the U.S., it is proposed that in today’s complex and uncertain times, past best practices are not helpful for promptly making decisions on unknown issues from diverse perspectives. Instead, the report suggests that behavioural norms should be sought in culture, and it provides recommendations on how to define and strengthen board culture as well as evaluate and rotate individual directors based on culture. Board culture can serve as a useful guideline for appointing and retaining directors who share the value of fulfilling stewardship responsibilities.

Compensation for independent outside directors

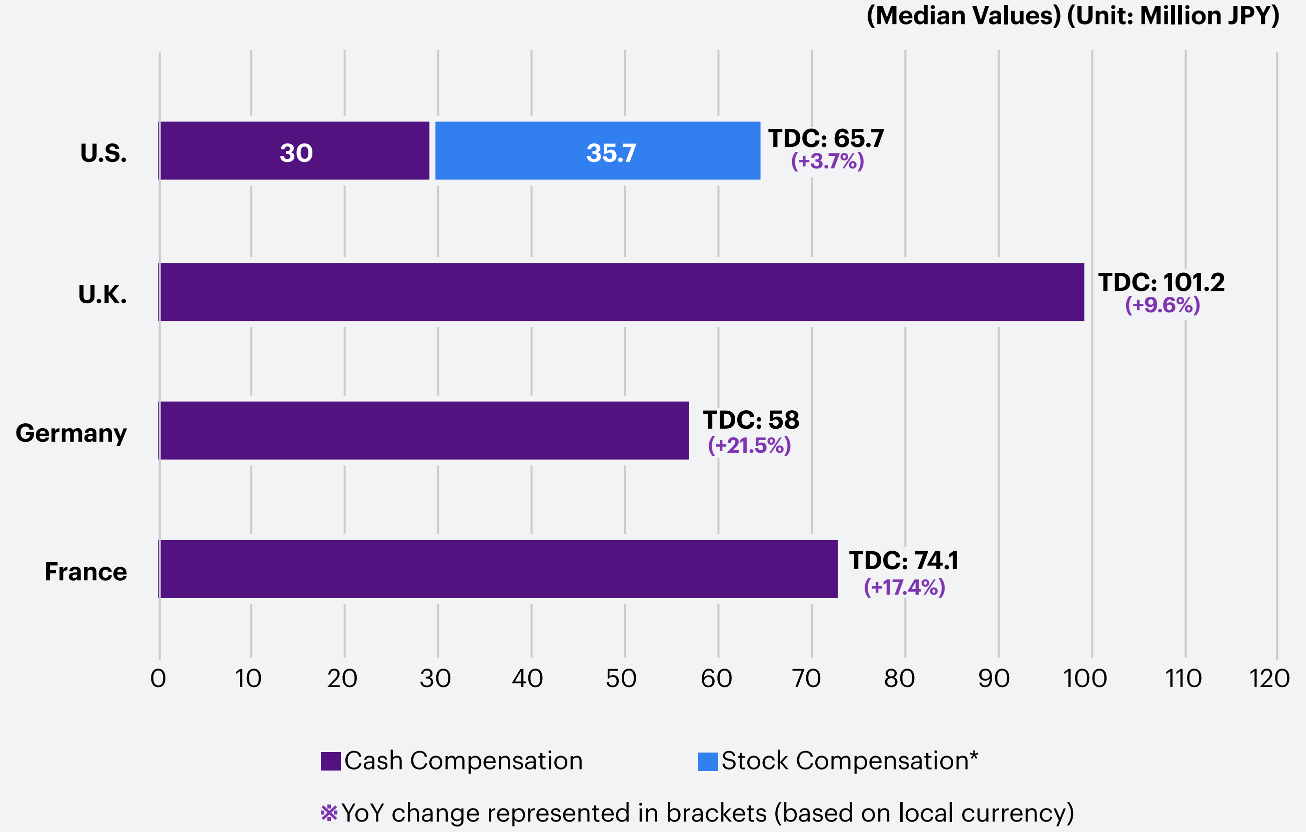
Lastly, the compensation of outside directors should also be reconsidered. For boards led by independent outside directors, a review of compensation should be considered from the perspective of enhancing the sense of responsibility among individual independent outside directors to fulfill their expected roles as well as compensating them for the longer time commitment required.

First, independent outside directors should be granted stock-based compensation. Stewardship responsibilities inherently entail the requirement of future-proofing, and stock-based compensation is the only way to instill this mindset. In addition, as Japanese companies in particular are said to need to make long-term value creation itself a key mission of the board, stock-based compensation without performance conditions may be acceptable as long as there are no concerns about the supervisory function.

Next, independent outside directors holding positions such as chair, lead independent director, committee chair or committee member should receive additional compensation commensurate with their significant responsibilities, differentiating their compensation levels. In particular, board chairs are required to commit substantially more time to the company than other independent outside directors, and their responsibilities are exceptionally significant. At Western companies, board chair compensation is set at a distinct level from other positions (Figure 2). Such practices are rarely seen among Japanese companies. The chair plays a pivotal role in strengthening board effectiveness, and there is ample room to reexamine fair treatment.

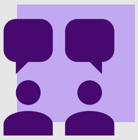
Finally, regardless of the amount, the individual compensation paid of independent outside directors should be fully disclosed. This is because shareholder oversight is the only way to ensure objectivity in determining their compensation. Individual disclosure of director compensation, along with disclosure of policy table for base retainers, position/committee membership fees and the amount of stock-based compensation, is a global norm. It can also serve as an opportunity for individual directors to become more aware of and increase their accountability for fulfilling their roles.

Figure 2: **Compensation for independent board chairs (median of companies with over 10 billion yen in revenue by each country, 2023 survey)**



*Stock compensation only shown for U.S. where grants to outside directors are considered common practice.

Overall, Japanese corporate governance is clearly making progress. However, there is still considerable scope for reform. In the face of the structural challenges of a shrinking market and workforce due to lower birth rates and an ageing population, it will be important to maintain this momentum in order to revitalise and prosper the Japanese economy.



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