JAPAN ASSOCIATION OF CORPORATE DIRECTORS

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Thank you for the opportunity again to speak in Japan about corporate governance. It is a subject about which I have been thinking for the last quarter century. Let me simply say – if you are worried that Japan has done too little about corporate governance in that period, I can comfort you that you have thereby avoided many mistakes which the rest of us have made. You do not have to repeat our mistakes. Let's begin at the beginning.

Savers around the world all search for a mode of investment through which they can earn the highest return at acceptable risk. Common stock of publicly traded companies provides investors with a particularly attractive blend of reward and risk, *but only so long as they feel that the market is honest.* Governance is about providing this assurance. Only if investors are convinced that they (1) are making decisions to buy based on reliable information and (2) that management is running the enterprise for their benefit will the market place value stocks attractively. Many studies in America have demonstrated that common stock investment earns higher returns over a ten-year period than any other category of investment, including particular debt investment of all kinds.

Each country will need decide the extent to which its policy towards corporations is to prioritize the development of wealth. Other considerations such as stability of employment or wealth leveling may be considered more important. Focus on wealth has certain public policy benefits. A conspicuous example is funding the costs for retirement income. Paying these costs with current revenues or from the proceeds of debt investments involves a high cost for this and succeeding generations. The availability of equities as collateral for the pension promise allows these obligations to be paid for at affordable cost. Possibly, the failure to insist on wealth creation as the objective of corporate management explains the lingering crisis in Japan's banking system.

There is no single formula for good global governance. What is appropriate for Japan may well not be appropriate for any other country. There is emerging, however, an orthodoxy of Global Governance expressed through a variety of Codes of Best Practice, issued by many institutional investors such as CalPERS and Hermes, many companies such as General Motors, and organizations such as the OECD and the World Bank. These codes are based in large measure in what is understood to be the Anglo/American model. Their logic is clear. Access to global capital markets – this means large Anglo/Dutch/American pension funds - is available to those who comply with global governance requirements. This raises the question – why would a country want access to global capital. Simply, because they need capital beyond the country's own capacity to generate in order to finance direct investment in business or public needs. There does not appear to be such a need for Japan. Therefore, there is no macroeconomic reason for Japanese companies to want to conform to global governance standards. Is Japan anxious to attract foreign capital to trade in the Stock Exchange markets?[1] Plainly, this has little to do with raising capital, but a great deal to do with assuring liquidity in the markets and, by increasing demand, having an upward bias on stock market values. There is a price; foreign portfolio capital can leave as fast it comes.

Rather than being concerned with the largely Anglo/American governance standards, Japan should first address the question of whether "wealth" can be efficiently adopted as the primary policy objective; and, only if that question is answered affirmatively turn to the creation of uniquely Japanese governance standards. The objective of these standards would be to increase the attractiveness of equity investment for Japanese individual, corporate and government savers.

We have said that there is no single formula for corporate governance that fits all companies and all countries. There are significant differences in language and culture. Consider the difficulty that the English and Americans have in communicating about boards of directors – they mean different things. And they certainly mean something different than a Japanese board. Beyond this is the problem of appearance and reality. Many of the so-called good governance staples like the importance of "independent" directors simply are not correlated to an increase in value of the company. So the celebrated McKinsey study showing a twenty percent value differential between well and poorly governed companies is based on appearance. Federal reserve Board Chairman Alan Greenspan recently debunked the prevailing governance wisdom when he dismissed the importance of directors in the American scheme and concluded that we actually exist in the "CEO dominant paradigm".

Here, we need pause, and stress the difference between "governance" and "management". Governance is about creating a framework within which a skillful management can create value. Governance does not create value; it helps assure a structure that prevents the needless destruction of value. Because America is unequivocally committed to the wealth model, Greenspan, an economist, is primarily focusing on the corporate structure that creates global competitiveness. He is concerned with governance only as it distracts from that objective. He would probably consider that a board strong enough to assure governance standards "may threaten America's entrepreneurial business culture" (Economist, June 19-25, 2002, p.70)

Having reviewed differences of language and perception, we should recognize that there are certain components common to effective governance everywhere. The most important of these is "transparency". Investors and the public generally must be able accurately to understand the financial aspects of a company's functioning. The information must be accurate, complete and comprehensible. Such practices as that of the American tobacco companies denying the effect of smoking on cancer when their own files demonstrated the opposite are unacceptable. Above all else, corporate information must be honorably compiled and certified.

A problem in every country is the assurance that information is reliable. Right now, the United States is suffering from the aftermath of hubris. All of the triumphalism of the '90s – GAAP as the superior accounting language; U.S. governance as the global preference; U.S. performance as the wonder of the world – has turned to ashes in the concern that trust has been destroyed. It is not only a concern with certain renegade companies such as Enron, Global Crossing and Tyco. The "best" companies in America used accounting practices that, with hindsight, appear dubious at best and criminal at worst.

Policy makers in the U.S. are desperately trying to understand what has to be done to restore confidence. The SEC unveils daily initiatives to demonstrate that its legendary competence survives, but the real work is being done by the Attorney Generals of several states, notably New York and Connecticut. There is widespread fear and belief that the "golden goose" has been killed. Popular belief in the "equity culture" is fragile. Much of modern American life is supported by the wealth created from the public ownership of corporations – not only has this stimulated individual consumption, but it has accounted for the virtual full funding of all of the pension costs for public employees and for about half of private company employees. Our failures of governance threaten to cost us dearly.

Japan is not immune from the problems of inadequate disclosure and ineffective enforcement. What are the mechanisms for enforcement in this country? Is there public enforcement through credible and competent government agencies? To ask the question is to answer it in the negative. Private enforcement through shareholder litigation – borrowed unhappily from the United States – is a disgrace. One need only ask. Why do the Japanese people persist in saving through the Postal Schemes with virtually a negative real rate of return? The answer comes back to Corporate Governance, and the lack of it. There is not a climate of trust with respect to equity investment.

Good governance – the assurance of integrity (but **not** the absence of risk) in equity investment – can enhance the quality of society. There are risks that have been inadequately considered in America (and that are currently being the subject of extensive discussion in the UK). The real problem is the definition of "the bottom line". American business has always taken pride in its focus on a simple "bottom line" - a numerical figure generated by the accounting profession, which has been accepted as the <u>*single*</u> measure of corporate performance. We have need to relearn in America the unhappy truth that there is no such thing as a rule or system that self executes. They must be effected by individuals. And there is no system that cannot be abused by individuals. The history of American business in the Nineties is a catalogue of such abuse.

The bottom line is more complicated than a simple or than several numbers (this has reference to the European intrigue with the "triple bottom line", which attempts to quantify social and environmental performance along with financial.). Corporate objectives must be harmonized with the values of society – what good does it do a pensioner to retire with adequate money into a dirty, unsafe and uncivil environment. The pensioner does not want to invest in companies that create such societal nuisances. There need be a persistent effort by society – whether through government, shareholder associations or other proxy – to assure that its long term concerns are reflected in the criteria for corporate performance. These evolving criteria comprise "value". Good governance can assure that management is held accountable to produce value as so defined. Essentially, governance is a question of openness and trust or clear management objectives and accountability. Governance is congenial both to Japan's traditions and to its future best interests.

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[1] Foreign capital in the stock markets is not "new money". It expands the amount of money available for the purchase and sale of already issued stocks. In that respect it is different from "direct" investment which represents new resources for investment by Japanese companies.