Are executive remuneration levels in Japanese companies fair?

The proportion of companies disclosing the cap of total pay for executive directors is limited to about 60%.

by **Kazutaka Kuroda** | December 20th, 2016

We've reviewed the broad trends of cash and stock incentives in major Japanese companies in two articles. The first, titled: 'Are Japanese companies getting executive incentives right, and how would investors know?' discussed cash incentives implemented by JPX-Nikkei 400 Index substitutes: link. This second part discusses the fairness of executive remuneration and stock options in a Japanese context.

Japanese companies have implemented stock options under the revised Commercial Code enacted in November 2001. Additionally stock incentives are highlighted in the context of corporate value creation of the Japan Revitalisation Strategy. The Supplemental Principle 4.2.1 of Japan's Corporate Governance Code clearly recommends a mix of cash and stock for executive remuneration. This resulted in about three fifths of the JPX-Nikkei 400 companies adopting stock incentives. However their schemes are not identical. They consist of some of the following:

- Performance shares: companies give shares to executive directors only when performance criteria are met
- Restricted stocks: companies provide executive directors non-transferable shares at their offering, but transferable after a pre-determined period, e.g. executive directors' tenure
- Trust: companies pay cash solely to buy the companies' shares in the market
- Stock options: companies issue stock options with a certain exercise price.

The most popular scheme is stock options with a one yen exercise price, which has been adopted by a third of the 400 companies. This replaced traditional fixed retirement benefits for executive directors in stock options, in order to comply with the Corporate Governance Code. However, restricted stock is more popular since the Ministry of Economy, Trade and Industry released a related guideline last June. At the beginning of August 2016, almost 10% of the 400 companies had introduced this type of stock incentive. Moreover, about 5% of the 400 companies implement schemes with the combination of performance shares and restricted stocks, e.g. offering shares depending on financial performance at the resignation of executive directors. These stock incentives seem easy to handle as mid-/long-term pay and reasonable to align interests of executive directors with those of the companies' shareholders. However share performance would not be the best proxy for performance of executive directors, since it is often influenced by sentiment and turbulence in the financial markets and therefore more variable than revenue and income. Of course, performance shares are dependent on meeting companies' financial targets.

To solve related problems, we suggest that companies should:

- Mainly offer cash incentives and limit the proportion of stock incentives in pay packages.
- Link the share price outperformance compared to those of peer companies to reduce factors such as financial market turbulence.

On the fairness of Japanese executive pay levels, companies have so far successfully avoided pay disputes between executive directors and employees and between the corporate sector and broader society. The UK High Pay Centre's report "Leading or Lagging?: Where Does the UK Stand in the International Debate on Top Pay?" appreciated Japanese executive pay packages, arguing that remuneration levels in Europe and North America were not aligned with the performance of board directors and employee/society expectations. It said that "Japanese pay packages focused on the country's stronger tradition of solidarity and humility, and the sense that prosperous companies succeed as a result of collective efforts rather than brilliant individual leadership".

Most Japanese companies take into consideration some degree of 'fairness' in executive pay levels. But the proportion of companies disclosing the cap of total pay for executive directors is limited to about 60% of the top 400 companies. These companies gain shareholders' approval in their AGMs. Most adopt a fixed pay cap. However, a variable pay cap linked to operating or net income, and a specific commitment to a consideration of the pay gap between executive directors and employees are, in our view, best for incentivise executive directors in line with stakeholder expectations. Such schemes were only adopted by 17 companies and 20 companies. It illustrates that there is huge room for improvement in disclosure by Japanese companies.

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