

Report by the Expert Committee on Desirable
Market Economy System

Expert Committee on Desirable Market Economy System

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Desirable market economy system

“Real Economy Driven”

under which market economy system can fully perform its following primary functions;

- Promoting medium- and long-term investments and active risk-taking and creating new core industries through innovation
- Returning the values created to various stakeholders
- Growing up personnel enabling to create values
- Accepting countries and regions with various cultures and traditions and contributing to the economic development of the world, including developing countries
- Co-existing with nature and the environment

Reconstruction of Japan's experiences by:

The securement of medium- and long-term funds for innovation that supports sustainable growth

Corporate governance to improve the overall corporate value

Improving communications including disclosure of non-financial information

The stability of the financial system that supports the growth of the real economy

Japan's experiences

- Finance of medium- and long-term investments through the main bank system and others
- Companies as a link between various stakeholders, concept of “sampo yoshi” (triple-win)
- Human resource development based on long-term employment system

Readily return to the past ✕

- Involvement of various stakeholders impedes decision-making.
- Medium- and long-term funds are provided aimlessly without careful thought on the future potential of the investment.
- The practice of long-term employment discourage adopting various ways of working.

✕ Excessive focus on the speculation-driven “money game” that pursues unsubstantial short-term profits leads to:

- A lack of medium- and long-term investments
- Overly uneven profit sharing

The securement of medium- and long-term funds for innovation that supports sustainable growth

<Medium- and Long-term funds >

Funds for innovation indispensable in increasing economic growth, competitiveness and employment through social infrastructure investments, corporate R&D activities and investments by venture companies, etc.

The background of necessity to medium- and long-term funds

Prevalence of short-termism

Pressure to improve business performance or carry out business restructuring from a short-term perspective

There is concern that such move may weaken companies' endurance capacity to consistently make efforts for innovation.

Investment judgment bound by requirements to maximize shareholder profits

Difficulty in maintaining the overall corporate value

Shareholder profits may be damaged.

【Challenges and future direction】

• Improvement of overall value and communication by companies

✓ Active communication, Transmitting information to various stakeholders, Presenting Medium-term management plan

• Improvement of investors' understanding and increase of the participation of individual investors

✓ Understanding that medium-and long-term investments foster companies and industries, Enhancement of financial literacy, Increase of the participation of individual investors(NISA*), Involvement of investors in companies' business operations, Appropriate fulfillment of intermediary functions by financial intermediates

* NISA: The Japanese version of the ISA, i.e. tax exemption for small amount investment

• Appropriate alignment of incentives for medium- and long-term investments throughout the equity investment chain

✓ Check and review of business performance evaluation and disclosure systems, which affect the behavior of investors and companies, as well as accounting standards that serve as the basis therefor

Corporate governance to improve the overall corporate value

The concept of “sampo yoshi” (triple-win)
(A business that benefits all of the seller, buyer and society is good.)

Build-up

Today’s corporate activities and their evaluations: It has become important to involve various stakeholders (shareholders, employees, customers, business partners and local people, etc.) in value creation, in such aspects as addressing environmental problems, seeking coexistence with local communities, and ensuring safety and security.

Corporate governance to prioritizing adjustments of interests of various stakeholders, and improving the overall corporate value from a medium-and long-term perspective

【 Challenges and future direction 】

- **Corporate governance prioritizing adjustments of interests of various stakeholders**
 - ✓ Outside directors can play significant roles in making reasonable judgments in order to improve the overall corporate value, while balancing the interests of various stakeholders.
- **Corporate governance that enables development and utilization of human resources along with regeneration**
- **Improvement of corporate governance through institutional investors’ fulfillment of their fiduciary responsibility**
 - ✓ The establishment of the Japanese Stewardship Code that shows the desirable involvement of institutional investors in investment destinations, to achieve sustainable growth of companies through constructive communications between institutional investors and companies.

Improving communications including disclosure of non-financial information

Financial information, such as ROE(return on equity) has only limited role to analyze companies.

Improvement

Non-financial information: Linking with management strategy in an objective and foreseeable manner (such as management philosophy, R&D activities, contributions to sustainability(reduction of environmental burden), and safety measures, etc.)

Necessity of communications in appropriate combination, including non-financial information

【 Challenges and future direction 】

- **Communications of the overall corporate value, including non-financial information**
 - ✓ Integrated reporting that shows the entirety of corporate activities makes investors and other stakeholders come to fully understand the overall value to be created by the company .
- **Communication of information as part of efforts to clarify management strategy**
- **Development of a system to communicate the entire picture of corporate activities**
 - ✓ Strengthening of partnership among related departments with elimination of sectionalism
 - ✓ It is important to secure and foster highly skilled personnel who can communicate with the market to enhance appeal to investors.

The stability of the financial system that supports the growth of the real economy

Leaning toward the “money game”
Excessive financial volatility caused by a major financial crisis



Damaging the functions of the financial system, and bringing about a serious negative effect on the real economy



Based on lessons from the Lehman Shock,

Discussions are being held on international financial regulatory reform under the G-20 framework.

【Challenges and future direction】

- **It is indispensable to establish a stable financial system and prevent major financial crises in advance.**
 - ✓ Institutional designers and financial institutions in Japan should continue to actively participate in and contribute to various initiatives for international financial regulatory reforms, while discussing desirable financial regulation
 - ✓ Effective supervision of financial systems through the macro-prudential policy, which is a framework for financial supervision to prevent any sign of deterioration in soundness observed in individual financial institutions or markets from spreading over to the entirety of the system

Conclusion

- **Under a desirable market economy system**
 - ✓ Companies will not take short-termism to merely try to reduce costs and result in diminishing equilibrium, but take actions to bring about expanding equilibrium.
 - ✓ Medium-and long-term investments and innovative activities will increase to achieve new growth that increases high-quality employment.
- A desirable market economy system is a mechanism which people both in and outside of Japan would like to join, and Japan needs to disseminate to the world.

*For a New
Growth of Japan*

Desirable Market Economy System “Driven by the Real Economy”

*Share Japan's appeal with people both in
and outside of Japan
Disseminate it to the world*

Companies (Receiver)

- **Improvement of the overall corporate value and communications of visions and concrete measures therefor**
- **Corporate governance to improve the overall corporate value from a medium-and long-term perspective**
 - Corporate governance prioritizing adjustments of interests of various stakeholders
 - ✓ Utilization of independent outside directors
 - Corporate governance that enables development and utilization of human resources along with regeneration
 - Improvement of corporate governance through institutional investors' fulfillment of their fiduciary responsibility
 - ✓ Japanese Stewardship Code
- **Efforts for improving communications including disclosure of non-financial information**
 - Communications of the overall corporate value, including non-financial information
 - ✓ Utilization of integrated reporting, etc.
 - Communication of information as part of efforts to clarify management strategy
 - Development of a system to communicate the entire picture of corporate activities

Corporate actions that lead to expanding equilibrium, increasing medium-and long-term investments and innovative activities, as well as high-quality employment

↑ ↑ ↑
Stable medium-and long-term funds

Appropriate alignment of incentives for medium- and long-term investments throughout the equity investment chain ⇒ Mutual trust

Check and review of business performance evaluation and disclosure systems, as well as accounting standards that serve as the basis therefor

Investors (Providers)

- **Swelling of the base of medium- and long-term investments**
 - **Improvement of the situation where short-termism prevails through enhancement of financial literacy**
 - ✓ While enhancing financial literacy, individual investors deepen their understanding that medium-and long-term investments foster companies and industries.
 - **Increase of the participation of individual investors (NISA)**
 - **Increased involvement of investors in companies' business operations through giving advice or exercising their voting rights**
 - **Appropriate fulfillment of intermediary functions by financial intermediates**
 - ✓ Departure from business models defined by the frequency and amounts of transactions

Financial system supporting the growth of the real economy

– **Necessity to achieve a stable financial system and prevent major financial crises in advance**

- ✓ Contribution to initiatives for international financial regulatory reform and effective supervision of financial markets through macro-prudential policy

- **Prevalence of short-termism → Pressure to improve business performance or carry out business restructuring from a short-term perspective → There is concern that such move may weaken companies' endurance capacity to consistently make efforts for innovation**
- **Investment judgment bound by requirements to maximize shareholder profits → Difficulty in maintaining the overall corporate value → Shareholder profits may be damaged.**
- **Reconstructing of Japan's experiences (provision of medium-and long-term funds, the concept of “sampo yoshi” (triple-win), human development through long-term employment, etc.)**
 - ~~✗~~ Taking an easy path to return to the past (indecisive corporate management, inflexible work styles)
 - ~~✗~~ Leaning excessively toward the speculation-driven “money game” that single-mindedly pursues unsubstantial short-term profits