CAPITALISM UNDER PRESSURE TO TRANSFORM QUALITATIVELY

– HAS THE TIME COME FOR A SHIFT TO STAKEHOLDER CAPITALISM? –

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SUMMARY

- Calls are growing for a shift to stakeholder capitalism, where companies serve all their stakeholders rather than only pursuing profit that prioritizes the return to their shareholders. There are several factors behind such demands, including the excessive pursuit of short-term profit, growing inequality, and increasing concern over the environment. To some extent, a rethinking of capitalism is indispensable.

- For the establishment of stakeholder capitalism, action by institutional investors is vital. Today, institutional investors are increasingly calling for companies to contribute to society, and a trend towards strengthening stewardship activities is also becoming apparent.

- It is expected that creation of common ESG disclosure standards would facilitate smooth dialogue between companies and their stakeholders, and lower the hurdles to making the shift to stakeholder capitalism.

1. MOMENTUM FOR A CHANGE IS MOUNTING FROM THE SHAREHOLDER PRIMACY TO STAKEHOLDER CAPITALISM

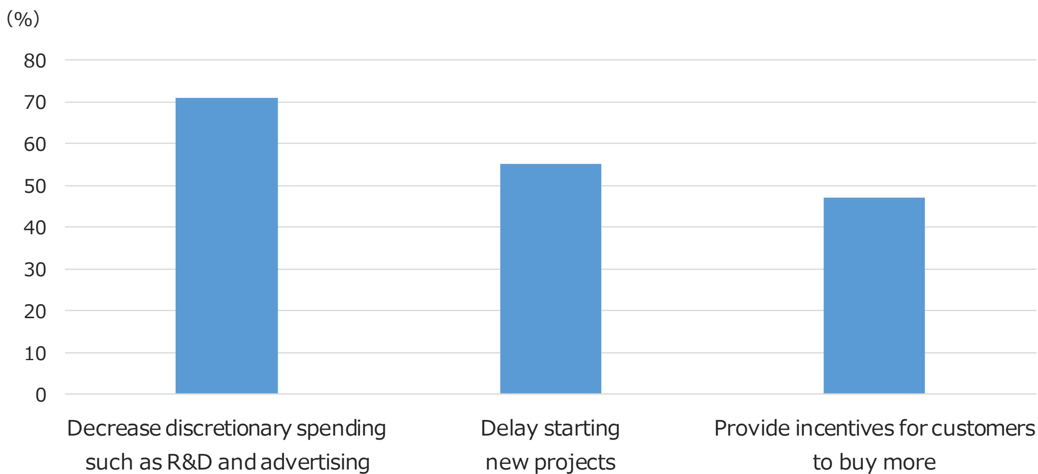
The distinctive characteristics of modern-day capitalism, such as shareholder primacy and short-termism, have led to serious problems, including growing inequality and environmental issues, and demands are growing for a qualitative review of capitalism. Specifically, the direction of change is towards what is termed “stakeholder capitalism”, a system that emphasizes a company’s relationship with its various stakeholders and seeks to raise long-term corporate value by sharing the fruits of the company’s activities with these stakeholders. As used here, the term “stakeholder” means a party with an interest in a company’s business activity, and more specifically, it refers to various entities such as customers, employees, business partners, local communities (which also includes the environment), government authorities, and shareholders.

In August 2019, Business Roundtable, an association of CEOs of US companies, released a policy statement committed to delivering value to all stakeholders. It is worth noting that the statement committed to providing profit from a long-term perspective to shareholders, who had previously been given paramount importance. In addition, the Davos Manifesto 2020 released by the World Economic Forum (WEF) states that companies should serve all of their stakeholders and not just shareholders. The manifesto also points out that companies are more than generators of wealth, and that their performance must be measured not only on the return to shareholders, but also on how they achieve environmental, social, and good governance objectives.

2. COMPLEX REASONS FOR RETHINKING CAPITALISM

Since a stock company is owned by its shareholders, the management responsible for operating the company are basically required to work for the shareholders. To ensure that management has an incentive to work for the shareholders, mechanisms have been introduced that link executive remuneration with the company's share price, for example, by granting stock options. As a result, the principle of shareholder primacy has led to short-termism, with management pursuing immediate profit. While short-termism has led to economic growth, excessive risk-taking has led to serious side effects, including economic crises such as the 2008 financial crisis. It has also resulted in a lack of medium- to long-term investment in growth. According to a survey by the US consultancy firm McKinsey, among the companies in which long-termism has not made up a part of their management-team culture, 71% responded that they would decrease discretionary spending if there were concerns that they would miss quarterly earnings targets, while 55% said that they might delay new projects, even if it meant sacrificing future corporate value (Fig).

Figure: Companies' actions when quarterly earnings target might be missed



Note: According to a survey by Mckinsey. Based on the responses of the 252 companies that did not report that "long-termism is a major part of management-team culture" among 358 companies.
Source: Rising to the challenge of short-termism, FCLT Global

Furthermore, shareholder primacy is considered to have given rise to the problem of inequality. The distribution of wealth to employees, one of the most important stakeholders of a company, has been deferred for the purpose of gaining immediate profit. The fact that prosperity can now be enjoyed only by company executives and a few other privileged players has engendered skepticism about capitalism (a positive view of socialism) among young people, particularly in the US and the UK. Moreover, with environmental issues, such as the increasing frequency of natural disasters, being recognized as an imminent threat, there is a renewed awareness that economic growth is premised on placing a huge burden on the natural environment, and that capitalism is not capable of solving these problems. As such, the issues caused by shareholder primacy and short-termism are both wide ranging and growing in severity, and it can be said that changes to the capitalism are needed to some extent. Most of the problems mentioned above are seen most prominently in the US and the UK, where the features of shareholder primacy have been evident. Japanese companies are considered to have been managed with the interests of not only the shareholders but also all stakeholders in mind, and the problems of excessive executive remuneration and shareholder returns are not common. However, Japanese companies need to understand that there is a growing tendency to evaluate companies in relation to social issues such as inequality and the environment, and such assessments are becoming increasingly stringent.

3. WILL STAKEHOLDER CAPITALISM REALLY TAKE ROOT?

3-1. The action of institutional investors holds the key

There is strong concern that pressure from the stock market in pursuit of short-term returns will hinder the transition from shareholder primacy and short-termism to stakeholder capitalism. Nevertheless, with the recognition that excessive short-termism led to the financial crisis, coupled with an increasing awareness of the importance of ESG in recent years, there is a growing tendency among institutional investors to focus on a company's long-term profit. It is expected that institutional investors will encourage companies to shift to stakeholder capitalism through such means as long-term shareholding and exercising their voting rights to provide support for the shift.

Moreover, there are signs that institutional investors are beginning to urge companies to take further steps to tackle social issues. Black Rock, the world's largest asset management company, is particularly active in this respect. In his annual letter to investee companies in 2018, Black Rock's CEO Larry Fink said, "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society." Furthermore, Black Rock has set itself the target of becoming the global leader in the area of sustainable investment, and is particularly increasing pressure on companies from an environmental perspective. For example, it plans to remove companies that generate more than 25% of their revenue from the production of thermal coal from its active investment portfolio by the middle of 2020, and has indicated that it may vote against companies that do not make sufficient improvements in terms of information disclosure and supportive action and plans relating to sustainability. Since other institutional investors are expected to follow Black Rock's lead, this is highly likely to provide a strong incentive for companies to shift to stakeholder capitalism.

In addition, revisions to stewardship codes could be one of the factors that will encourage companies to make the shift to stakeholder capitalism. A stewardship code is a set of principles designed to encourage a wide range of institutional investors to engage in constructive dialogue with companies and fulfil their fiduciary responsibilities appropriately, from the viewpoint of promoting the sustainable growth of companies. In recent years, ESG elements have been added to these principles. In the UK Stewardship Code, which was revised in October 2019, stewardship is defined as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society." Revisions to Japan's Stewardship Code are also being considered to include the ESG elements. While stewardship codes are soft laws and are not legally binding, their influence is growing, as seen, for example, in Japan, where the number of institutions that have accepted the code has been increasing since its establishment in February 2014.

3-2. The reasonability of the shift to stakeholder capitalism for companies

Taking a proactive approach toward stakeholder capitalism is also advantageous for companies. In a poll of US citizens conducted by JUST Capital[1], 74% of respondents said that they would choose to work for a company that treated its stakeholders fairly, even if it meant taking a 10% cut in salary (66% said that they would accept a reduction of 20%). This suggests that focusing on stakeholders may be an effective strategy for acquiring excellent human resources amid a tight global supply and demand situation caused by aging societies and other factors. Furthermore, when US listed companies are ranked based on a score relating to various issues (solutions) with their stakeholders[2], the highest ranking group of companies is shown to have an ROE 6.4% higher than the lowest ranking group, while the investors' valuation or the price-to-book ratio of the lowest ranking group of companies is 2.7 compared to 3.8 for the highest ranking group (JUST Capital[3]). As mentioned

[1] 'A ROADMAP FOR STAKEHOLDER CAPITALISM 2019JUST Capital's Survey Results' JUST Capital

[2] Each company was given a score based on 29 indicators selected on the basis of a survey of US citizens who were asked how a "fair company" should behave towards five specific groups of stakeholders, i.e., workers, customers, communities, the environment, and shareholders. The indicators included "Pays a fair wage", "Protects customer privacy", and "Minimizes pollution", and the number of indicators were different for each stakeholder group.

[3] "JUST BUSINESS, BETTERMARGINS" JUST Capital

above, focusing on stakeholders may be disadvantageous as far as short-term stock price trends are concerned, but it is most likely to be advantageous in terms of evaluating essential corporate value.

So what exactly should companies do? In short, a company should decide on what kind of relationship it wants to build with its stakeholders who have varied expectations and understanding of issues, and how it should allocate its resources. Because the actual allocation of resources will involve financial expenditure, such as investment in employee training and R&D, as well as investment in the local community, increased disclosure of information, from both qualitative and quantitative perspectives, is likely to be required to gain the understanding of shareholders and other stakeholders. However, since the relationship with stakeholders is different for each company, and there are no one-size-fits-all criteria for judgment, it is difficult to decide on the extent to which information should be disclosed.

Of note in this respect is the draft framework on the disclosure of ESG metrics launched by the WEF in January 2020 in collaboration with the Big Four accounting firms, namely, Deloitte, EY, KPMG, and PwC[4]. The proposal contains 22 core items, arranged under the four pillars of Principles of Governance, Planet, People, and Prosperity, to be used internationally as common tools for companies to demonstrate their sustainable value creation. To avoid increasing the burden on companies, the proposal stresses that it is possible to draw from existing standards on information disclosure, such as GRI (Global Reporting Initiative), SASB (Sustainability Accounting Standards Board), and TCFD (Task Force on Climate-related Financial Disclosure) standards, rather than creating new ones. The framework will be finalized in the coming months after consulting with regulatory authorities, investors, and other stakeholders. While it is unclear whether this proposal will be widely accepted in the future, according to the WEF, many of the world's largest companies have already responded positively to the idea of including the proposed metrics and disclosures in their annual reports and other publications. Moreover, given the authority bestowed on the proposal by the participation of the Big Four accounting firms, there is a good possibility that there will be a groundswell of support for the proposal. It is expected that widespread acceptance of unified ESG disclosure would facilitate smooth communication between companies and stakeholders, and make it easier for companies to make the transition to stakeholder capitalism. In addition, if the majority of companies adopt unified ESG disclosure, it will begin to position as a formal system, making it necessary for companies that have been slow to respond to follow this trend. As a result, this will eventually provide a strong impetus for the shift toward stakeholder capitalism. For these reasons, the establishment of common ESG disclosure standards can be said to be an extremely important factor in realizing stakeholder capitalism.

The Davos Manifesto 2020 mentioned above contains the statement "Executive remuneration should reflect stakeholder responsibility". Until now, executive remuneration has generally been linked to a company's performance and its stock price. However, the German conglomerate Siemens has announced that from 2020, 20% of the company's stock-based portion of executive compensation will be linked to performance measured on the basis of an internally calculated sustainability index. The index comprises three metrics: reduction of CO_2 emissions, the number of training hours per employee, and the degree of customer satisfaction. For companies seeking to make the shift to stakeholder capitalism, such a measure would be an effective means for aligning the direction of management and demonstrating that commitment both inside and outside the company, and is therefore likely to gain momentum in the future.

[4] "Toward Common Metrics and Consistent Reporting of Sustainable Value Creation" issued by WEF http://www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf

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