Playing catch up – the challenge for Japan

Japan has been a notable laggard in two critical areas – climate change and gender equality, while serious governance issues at Toshiba have heightened investor concern. How are we engaging with Japanese companies and policymakers to accelerate the energy transition and support women in the workplace?

Setting the scene

In late October 2020, Japan's Prime Minister Yoshihide Suga set a target[1] for carbon neutrality by 2050. However, Japan is struggling to phase-out coal-fired power plants and ramp up its renewable energy capacity, while the financing of coal-fired power stations overseas by Japan's banks has attracted investor ire.

Meanwhile, Japan was ranked 121st in the Gender Gap Index in 2020, the worst performance among developed nations. It also ranked 131st in terms of the proportion of women in senior and leadership positions, well below the world average, while ranking poorly in terms of the gender pay gap.

All eyes were on Japan this summer as Tokyo hosted the Olympic and Paralympic games. The host nation had blotted its copy book in the run up to the games following sexist comments from Japan's Tokyo Olympics chief Yoshiro Mori and the Summer Games creative director, showing how far Japan still needed to go to address gender equality. However, in a sign of changing sentiment, both men resigned in the wake of widespread condemnation from Japanese companies and the media, and Mori was replaced by a woman.

Poor progress on gender equality is just one of the challenges facing Japan. It also has an uphill battle to align with the Paris Agreement, due to its reliance on coal-fired power, while the governance scandal at Toshiba has highlighted the outdated thinking and practices that still predominate at some boards.

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[1] https://www.theguardian.com/world/2020/oct/26/japan-will-become-carbon-neutral-by-2050-pm-pledges

Challenges facing Japan

Gender equality

Women are underrepresented in the Japanese labour force, particularly at senior levels. The lack of day-care facilities, as well as cultural stereotypes that place a greater burden on mothers, have forced many women to lower their ambitions. Nearly half of women quit their jobs after having their first child. Another problem is that many companies have a non-career track and a career track, the latter requiring a willingness to relocate regularly. This tends to sideline women as it makes it difficult for both husbands and wives to develop their careers, and many women still choose the non-career track. This has contributed to the slow change in male-dominant working practices, despite the government's commitment to hiring and promoting more female employees. This has a significant opportunity cost for companies, the economy and wider society.

Climate change

With most nuclear power plants still offline in the wake of the Fukushima disaster, and strong opposition to restarting them, Japan relies heavily on coal. The draft 2021 Sixth Basic Energy Plan says that inefficient coal-fired power stations will be shut down. However, the plan retains coal as a core energy generator by supporting coal projects that use mixed combustion with ammonia for power generation, accounting for 19% of the energy mix in 2030. This will not be compatible with a 1.5°C pathway.

The country has little renewable energy capacity to draw upon instead. The current target, setting out the country's energy mix to 2030, envisages renewables accounting for at least 36-38% of the power generated. But such targets will need to be revised upwards if the country is to meet its carbon neutral goal and the Paris goals. Push back is expected from the utility sector, which has argued that coal is required in the short term to ensure a stable electricity supply.

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Governance/shareholder protection

Corporate Japan has a fractious relationship with minority and overseas shareholders, and this was illustrated once again by the recent scandal at Toshiba. An independent report into whether Toshiba's 2020 shareholder meeting was conducted in a fair and impartial manner alleged that Toshiba's management had "worked closely" with Japan's Ministry of Economy, Trade and Industry (METI) to exert "undue influence on some shareholders".[2,3] The individuals said to be involved denied the allegations. Shareholders and their representatives, including EOS, had pushed for the report and at the 2021 annual meeting, Toshiba's chair was ousted, a significant development for investor stewardship in Japan.

Our engagement approach

Gender equality

We have accelerated our engagement with Japanese companies on equality and diversity in recent years and in 2019 we started to incorporate this into our voting policy for Japan. We initially recommended voting against companies where there were no women among the directors or statutory auditors[4]. We would recommend a vote against the chair of the nomination committee if this individual was known, and target the chair or president if the company did not have a nomination committee or identify the chair of the committee.

In 2020, we raised our expectations for TOPIX 100 companies, wanting to see women account for at least 10% of board members. This was in line with the target set by the 30% Club Japan Investor Group, which we joined shortly after its launch in 2019. The first female directors were appointed in 2020 at many companies including Nintendo[5], SoftBank Group[6] and Suzuki Motor[7], following our engagements and escalations through voting in the previous year.

In 2021, we tightened our policy to recommend a vote against responsible directors at companies with no female directors, not counting statutory auditors as they do not have voting rights at board meetings. Our threshold for TOPIX 100 companies is 10%. Appointing just one woman is not sufficient – companies should be developing talent pipelines, with supportive policies to help women progress.

In addition to board diversity, we have engaged on gender diversity in management roles and the wider workforce. While encouraging companies to set targets on the proportion of women managers and other metrics for gender equality, we also focus our engagements in the following practical areas, to encourage companies to make the changes necessary.

Mid-career hires

Increasing female mid-career hires will help companies to improve their gender diversity particularly at middle management and more senior levels so that women who have taken career breaks can return to the workforce more easily. We encourage companies to invest more in this area and set specific targets, particularly around the intake of female candidates. Financial services group Orix has made a large number of mid-career hires, accounting for about 60% of its total new hires.

[2] Probe finds Toshiba colluded with government | Financial Times (ft.com)
[3] https://www.reuters.com/world/asia-pacific/independent-probe-says-toshiba-agm-last-year-was-not-fairly-managed-2021-06-10/
[4] The majority of Japanese companies have a two-tier board system with a board of directors and a board of statutory auditors.
[5] https://www.hermes-investment.com/uki/eos-insight/eos/nintendo-case-study/.
[6] https://www.hermes-investment.com/uki/wp-content/uploads/2021/04/public-engagement-report-q1-2021-spreads.pdf.
[7] https://www.hermes-investment.com/ukw/wp-content/uploads/2020/10/eos-public-engagement-report-q3-2020-spreads.pdf.

Relocation culture

Japanese companies typically rotate employees between different jobs and departments to train 'generalists', often involving relocations to different parts of the country or overseas. Such a system may have worked in the past when most women stopped working after getting married or starting a family, and were able to follow their husbands, but it is unsustainable in today's world where many women wish to develop their own careers.

We have urged companies to review this approach and switch to a modern working style. Hiring local talent instead of sending people around the country would also help to create jobs in smaller cities. NTT Group recently announced a plan to allow employees to choose where they work and abolish relocations, as part of a comprehensive management reform. We have engaged with many companies on this including Sony, Seven & I Holdings and Yaoko.

Paternity leave

Although Japan offers one of the most generous paternity leaves in the world[8], only a small percentage of men take this, and there have been reports of harassment of men who do.[9] Companies should put more effort into changing their culture and the perceptions around taking parental leave, as well as setting targets for the paternity leave take-up rate. We have engaged with Honda, which has set a target to increase the percentage of men taking childcare leave to at least 30% by 2025. Mitsubishi UFG Financial Group (MUFG) offers 10 days of paid leave as parental leave and encourages male employees to take an additional 10 days of annual leave.

Working style/culture

Long working hours and a presenteeism culture can also prevent women's progression. We expect companies to implement measures to significantly improve work-life balance for all employees, by setting ambitious targets on reduced overtime and annual leave take-up, and being accountable for achieving them. This may require fundamental cultural change.

For example, Honda has implemented various measures to systematically encourage employees to use all their annual leave entitlement. As a result, a high percentage of annual leave take-up has been achieved, helped by its strong trade union. It also has set every Wednesday and every other Friday as 'no overtime day', to reduce working hours.

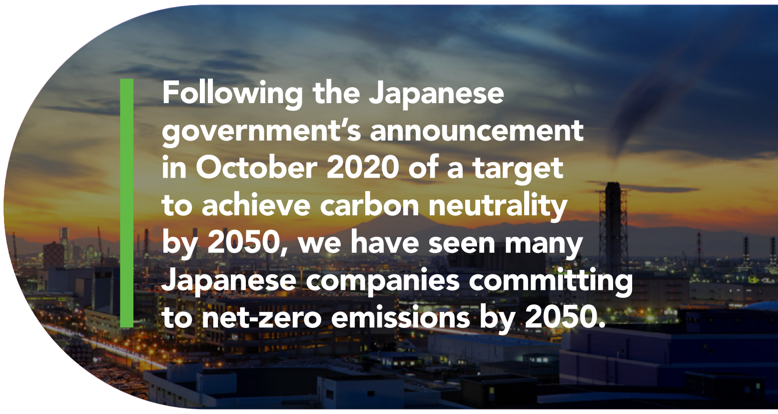
Pipeline challenges

We engage with companies on supporting girls to take up science and engineering degrees, as technology and manufacturing make up a significant part of Japan's economy. Toyota runs programmes to support female engineers, including loans to undergraduate and postgraduate students, which do not need to be repaid if the recipient joins one of its supporting companies. Half the amount needs to be repaid if the recipient joins another manufacturer. It is also important to educate male-dominated management about the importance of diversity and inclusion, and unconscious biases.

Climate change and the energy transition

Following the Japanese government's announcement in October 2020 of a target to achieve carbon neutrality by 2050, we have seen many Japanese companies committing to net-zero emissions by 2050. While this is the right goal for many companies, some sectors may need to achieve net zero sooner (such as utilities by 2040). Also, emissions must fall rapidly in line with science-based targets and the goal of reducing global emissions by 50% by 2030.

In addition to our company engagements, since 2019 we have incorporated various metrics into our global voting policies to measure how well companies are addressing climate change. We have written to the chairs of companies scoring below a Transition Pathway Initiative Level 3 management rating (Level 4 for companies with a high exposure to fossil fuels), planning to recommend a vote against them if our engagement does not give us assurance about their management of climate-related risks. In 2021, we introduced additional criteria, where we would consider recommending voting against the chairs of companies deemed to be expanding their coal exposure, or with high deforestation risks.



Shareholder proposals

Japan saw its first climate-related shareholder proposal in 2020, filed at Mizuho Financial Group. We supported the proposal, which attracted significant support, including from proxy advisers ISS and Glass Lewis. In the 2021 voting season, two similar proposals were filed at MUFG and Sumitomo Corp, asking the companies to align their business strategies with the Paris goals. These companies were targeted for their significant exposure to coal. We accelerated our engagements with them, while also having discussions with the NGOs who filed the proposals, before recommending support for both and publicly expressing this.

The proposal at Sumitomo received 20% support, including from EOS, despite a lack of support from Glass Lewis, while the one at MUFG received 23% support without support from either Glass Lewis or ISS. This showed the high level of interest from shareholders. The success of these proposals and the increased shareholder engagement have not only accelerated change at the target companies, but have also impacted other Japanese companies, particularly industry peers.

[8] Are the world's richest countries family friendly?: Policy in the OECD and EU (unicef-irc.org)
[9] Japanese man sues Asics, saying he was punished for taking paternity leave | Japan | The Guardian

Collaborative engagements and industry initiatives

We are currently co-leading the collaborative engagement with MUFG as part of the Institutional Investors Group on Climate Change's Net Zero Investor Expectations for Banks initiative. This sets out how banks should demonstrate alignment with the goals of the Paris Agreement. The expectations cover three key areas: the action banks should take to align their financing activities with the Paris goals; steps to strengthen governance to ensure delivery of net zero commitments; and disclosure to demonstrate implementation. An assessment framework for the sector will be developed in partnership with the Transition Pathway Initiative (TPI) to facilitate company and investor dialogue.

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In early July 2021, Mizuho became the first Japanese bank to join the Partnership for Carbon Accounting Financials (PCAF), a global, industry-led initiative that enables financial institutions to measure and disclose the indirect greenhouse gas emissions of their loans and investments. We have engaged with Mizuho about its financing of new coal-fired power stations, and this was an encouraging step. Following support from 34% of shareholders for the climate change resolution at its 2020 shareholder meeting, Mizuho announced an earlier target of ending coal-fired power plant financing, bringing it forward by 10 years to 2040. However, we continue to engage on this topic in pursuit of Paris alignment.

EOS is also co-leading the engagement with Japan's Chubu Electric Power as part of the AIGCC's Asian Utilities Engagement Program (see page 8) and is a collaborator on the J-Power engagement. These companies need to set clear decarbonisation strategies, to phase out their coal-fired power stations and align with Paris.

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CASE STUDY

Inpex

EOS began engaging on climate change with Japanese energy company Inpex in early 2017, when we challenged it to clearly articulate its long-term strategy, addressing climate change issues and stranded assets. Inpex develops upstream oil and gas projects so the transition to a low carbon economy is particularly material. Nearly 20% of the company is held by Japan's Ministry of Economy, Trade and Industry, which we believe might make it more difficult for the company's strategy to deviate from the government's energy policy.

We continued to engage in 2018 and 2019, when we again shared our view that the company's target to increase renewable energy to 10% of its portfolio by 2040 appeared unambitious. In a call with the company in early 2020, we reiterated that it should set a more stretching target than that of reducing greenhouse gas emissions by 28% by 2030 from a 2013 baseline. We also challenged the company to set a net-zero goal by 2050, in line with its global peers.

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Inpex has improved its disclosure on climate change in recent years, with more detailed scenario analyses. In a meeting with the company in early 2021, we welcomed the announcement of a 2050 target to achieve net-zero emissions for Scopes 1 and 2, with additional targets on methane and flaring. It also has plans to promote carbon capture and storage, a hydrogen business, carbon recycling and renewable energy. We said that we would like to see an ambitious target for Scope 3 emissions, and encouraged it to set a 2030 target to reduce absolute emissions, as the current 2030 target is to reduce carbon intensity. We continue to engage with Inpex on this and its capital expenditure plans, as well as increasing renewable energy in its portfolio.

Governance/shareholder protection

The recent governance scandal at Toshiba and the ousting of the board chair may encourage a change in attitude at Japanese companies towards minority shareholders. EOS has engaged with Toshiba for many years on its governance practices, particularly following the accounting scandal in 2015.

We wrote to the board in September 2020 to express our concerns about the 2020 shareholder meeting and requested an independent investigation. We reiterated our message at a subsequent meeting with three independent directors, including the audit committee chair, in October 2020. We then supported the shareholder proposal at the special shareholder meeting in early 2021 to seek an independent investigation into the operation of the 2020 annual shareholder meeting.

At the subsequent 2021 annual shareholder meeting, which was held in the wake of the damning report into the conduct of the 2020 meeting, we recommended votes against the chair, the CEO and the incumbent members of the board. This was due to the board's failure to hold management to account or to protect shareholder interests. We were also concerned by the investigation's finding that the audit committee had failed to fully perform its function.

> **The aim was to send a strong message that far-reaching reform and a fundamental change of culture at Toshiba's board were necessary in order to regain investor confidence.**

Two audit committee members, including the chair, stepped down, along with two senior executives, but we believed the whole board should be held accountable. Therefore we recommended voting against all seven incumbent directors who were standing for re-election. The aim was to send a strong message that far-reaching reform and a fundamental change of culture at Toshiba's board were necessary in order to regain investor confidence. We continue to engage with the company on proposals for further board candidates and will consider escalating our votes if we are not satisfied with the new members and their role.

We have also accelerated our engagement on cross-shareholdings in recent years, highlighting the impact on governance practices and pressing for a significant reduction. In 2020, we started to recommend voting against the non-executive directors who represent each company's cross-shareholding partners. From 2022, we plan to recommend a vote against the top executives of those companies with a substantial amount of these holdings.

Outlook

In the coming months we will continue to press for better governance practice, which we believe underpins and drives the management of other key issues. We will strengthen our voting policy and support appropriate shareholder proposals to this end.

We will also advocate for enhanced gender diversity on boards and across the workforce, making specific recommendations as we have outlined. To address the climate crisis, we will leverage collaborative engagements with the companies and regulators that we believe hold the key to accelerating the transition.

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