ESG Working Group Report

January 2017

Working Group on Incorporating Issues Regarding
Sustainability into Investment
(ESG Working Group)

Unofficial translation to be used solely as reference to aid in the understanding of the original Japanese text, which can be found on the following Ministry of the Environment website:　http://www.env.go.jp/policy/esg/pdf/rep_h2901.pdf

ESG Working Group Report

Japan's Stewardship Code and Japan's Corporate Governance Code were established in February 2014 and June 2015 respectively in Japan as part of the Japan Revitalization Strategy. The principles in the Codes should be applied in a manner suited to each individual investor or company's specific conditions and situations. In Japan's Stewardship Code, relevant factors are set out that may be considered by institutional investors when monitoring a company in order to increase the medium- to long-term value of investee companies, including "risks arising from social and environmental matters" in addition to "governance" at the investee companies.

Against this backdrop, the Government Pension Investment Fund (GPIF), with the largest pension assets in the world, signed the United Nations (UN) backed Principles for Responsible Investment (PRI) in September 2015. This has acted in Japan as one catalyst for increased awareness and interest in incorporating information related to the Environment (E), Social (S) and Governance (G) into investment, or so called "ESG investment".

With these recent developments in "ESG" in Japan, and following nine meetings starting in October 2015, the "Working Group on Incorporating Issues Regarding Sustainability into Investment" (ESG Working Group) has produced the attached Guidebook aiming to improve fundamental understanding of ESG investment, with a particular focus on "E". Hearings were conducted primarily with members of the Working Group and issues debated further while looking at their various circumstances; the views of related parties who attended as observers were also obtained. The Working Group also held a symposium together with the "Principles for Financial Action towards a Sustainable Society (Principles for Financial Action for the 21st Century; PFA21"[1] in March 2016 to promote and disseminate ESG investment, and communicated our message to a wide audience.

Going forward, the Working Group hope that the Ministry of the Environment (hereafter "MOE") will continue to coordinate with other relevant parties to promote and disseminate ESG investment, so that each entity comprising the investment chain may effectively utilize this Guidebook and further their ESG investment activities.

---

[1] The creation of the Principles for Financial Action for the 21st Century (number of signatories at end December 2016: 250) was led by a Drafting Committee comprised of financial institutions, based on the proposals in the report produced in June 2010 by a subcommittee (expert committee on the environment and finance) of the General Policy Committee of the Central Environment Council to the Minister of the Environment, "Towards Green Finance, the New Role of the Financial Sector in Building a Low Carbon Society". Specifically, it was created as behavioural guidelines for financial institutions who wish to fulfill their responsibility and role necessary to protect the future of the planet and create a sustainable society, and as a starting point for financial institutions with the same desire to work together without being restricted by sector, size or geography. The report in Japanese can be found on the following MOE website: http://www.env.go.jp/council/02policy/yoshi02-11.html

Working Group on Incorporating Issues Regarding Sustainability into Investment (ESG Working Group) Participants

Chair

Tetsuo Kitagawa	Professor of Graduate School of International Management, Aoyama Gakuin University

Committee Members

Masao Asano	Partner, Financial Services Industry Group, Deloitte Touche Tohmatsu LLC[2]
Naoki Adachi	Chief Executive Officer, Response Ability, Inc.
Masaru Arai	Chair, Japan Sustainable Investment Forum
George Iguchi	Head of Corporate Governance, General Manager of Equity Investment Department, Nissay Asset Management Corporation
Shizuko Ohmi	Head of ESG Department, Research Group, Investment Management Division, Amundi Japan Ltd.
Sakae Oguma	Director, Social Policy Division, Department of Economic and Social Policy, Japanese Trade Union Confederation
Naoyuki Kainuma	Integrated Report Team Leader, Sustainability & Corporate Responsibility, Deloitte Touche Tohmatsu LLC[3]
Tsukasa Kanai	Chief Sustainability Officer, Corporate Planning Department, Sumitomo Mitsui Trust Bank, Limited
Keisuke Takegahara	General Manager, Economic & Industrial Research Department, Development Bank of Japan Inc.
Shunsuke Tanahashi	Partner, Ark Totan Alternative Co., Ltd.[4]
Hiroko Tokuda	ESG specialist, Investment Research Group & Responsible Investment Group, Tokio Marine Asset Management Co., Ltd.
Koji Tobita	Chief Executive Officer, Tactical Asset Consulting, Ltd.
Hiroki Nakagawa	Chief Operating Officer, Director, FISCO IR Ltd.
Minoru Matsubara	Chief Manager, Asset Management Business Planning Division, Resona Bank, Ltd.
Takeshi Mizuguchi	Professor, Takasaki City University of Economics

Observers

Industrial Finance Division, Economic and Industrial Policy Bureau, Ministry of Economy, Trade and Industry

Corporate Accounting and Disclosure Division, Planning and Coordination Bureau, Financial Services Agency

Planning Section, Listing Department, Tokyo Stock Exchange, Inc.

Secretariat

Environment and Economy Division, Environmental Policy Bureau, Ministry of the Environment

Deloitte Touche Tohmatsu LLC

---

[2] Committee member in FY2015

[3] Committee member in FY2016

[4] As of November 30, 2016

Attachment

Introduction to ESG Investment

Working Group on Incorporating Issues Regarding Sustainability into Investment
(ESG Working Group)

Contents

Introduction

Historical Context

If the history of the 20th Century is reviewed from the point of view of "economic activity and the environment", debate led by the United Nations (UN) concerning economic growth and environmental issues became more frequently heard globally from the 1970s. More than 40 years have passed since then, but economic growth and the sustainability thereof without proper medium- to long-term regard to the earth's finite environmental resources, still continue to be a fundamental issue, with ever increasing carbon dioxide emissions and worsening environmental problems on the back of increased global warming.

The Paris Agreement[1], adopted on 12 December 2015 at the 21st Session of the Conference of the Parties of the United Nations Framework Convention on Climate Change (hereafter "COP21"), is a fair and effective global framework in which all countries participate, and holds historical meaning. In the Paris Agreement, a long-term goal was set to maintain the rise in the earth's average temperature from the industrial revolution to well below 2 degrees C, and pursue efforts to limit it to 1.5 degrees C (hereafter "2 degrees C goal"). Rules were also incorporated requiring all countries to create, submit and maintain targets to reduce the emission of greenhouse gases, implement domestic measures to achieve these targets, and further renew and resubmit targets every five years. In particular with respect to the 2 degrees C goal, the determination to reduce the worldwide artificial emission of greenhouse gases by 40% to 70% compared to 2010 by the year 2050, and try to achieve equilibrium in the second half of the 21st century between the artificial emission of greenhouse gases and their absorption so that emissions are zero or less in 2100, means that "decarbonisation" was pronounced as the shared will of the world, and as such our responsibility is great.

In modern times, and especially since the industrial revolution, we have realised economic growth through the aggressive development and use of the earth's resources. Until the second half of the 20th century, consideration of the volume of carbon dioxide emissions was not particularly necessary, however much we burned fossil resources such as coal and oil. This is due in large part to the earth with its diverse ecosystem absorbing the carbon dioxide that was emitted and cleansing any pollution; our economic activity owes much to this earth's self-cleaning/regeneration mechanism. Whereas going into the 21st century, various measures led by the UN have been adopted and implemented by the international community, on the back of a heightening sense of crisis with regard to the sustainability of society, the economy, and the environment. Numerous initiatives have arisen led by organisations such as the United

[1] The Paris Agreement went into effect on 4 November 2016, and Japan deposited its instrument of acceptance on 8 November. A summary of the Paris Agreement in Japanese can be found on the following MOE website:
http://www.env.go.jp/policy/hakusyo/h28/index.html

Nations Environment Programme - Finance Initiative (UNEP FI), the United Nations Global Compact (UNGC), and the Principles for Responsible Investment (PRI), on the recognition that action to tackle global warming and other issues by financial institutions and corporates in particular is crucial. However, the long-term goal of the Paris Agreement to some extent goes beyond the UN's initiatives so far, and it is understood based on scientific analysis that the earth's ability to self-clean/regenerate is limited, and we are approaching that limit. In this way, the relationship between economic growth and the environment in the 21st century has fundamentally changed from the 20th century. This Guidebook takes this historical context as its departure point.

The long-term investor as the main agent of ESG investment

The type of long-term signals (information on business risks and opportunities) regarding corporate activity promulgated by the Paris Agreement are unlikely to be considered by investors who act from a short term perspective, as their time frame differs. In this way, the scope and depth of information considered, and how the future is seen and understood can change depending on the time scale. Thus investors who inherently ought to consider information about companies from a medium- to long-term standpoint (hereafter "long-term investors"), may be unable to properly visualise and evaluate a company's growth path or future prospects and as a result make bad investment decisions, if they ignore long-term signals such as the long-term goal of the Paris Agreement, and continue to behave based on the short term. In other words, long-term investors can only hope to further improve the relevance of their investments and optimise their investment portfolio, by being aware of the importance of the medium- to long-term time horizon in their investment analysis and decision making process, and working to eliminate the asymmetry in information about companies.

When long-term investors are brought into the equation, an intimation as to how the relationship between "economic activity and the environment" can be reversed and how sustainability can be increased, can be found in the roles played by long-term investors and companies. For example, if long-term growth in carbon dioxide emissions does not slow considerably, as set out in the Paris Agreement, and if global warming progresses at the current or at an even more rapid pace, the environment will suffer far worse damage. As a result, climate change risk will be greater, in terms of both scale and substance, than economic activity can bear, and many companies will face the risk of losing a stable natural environment, assumed as given in their pursuit of sustainable growth.

Long-term investors, however, can choose to take action with their investments to improve the current outlook or prevent such a scenario, from the point of view of encouraging the sustainable growth of firms. This should act as a catalyst for companies to further their understanding of the precarious standing of the environmental stability upon which their growth depends, and focus on optimising their risk management and creating value from a medium- to long-term perspective to achieve sustainable growth. In this context, for both long-term investors and corporates, initiatives and solutions to issues regarding the sustainability of the environment are a "means" for companies to achieve sustainable growth. And the incorporation of information on the Environment, Social and Governance into investment, or so called "ESG investment", should provide a valid perspective for long-term investors and firms who look to achieve sustainable growth through such means.

Objective of this Guidebook

This Guidebook aims to provide everyone with an interest in such a perspective, an aid to building a basic understanding of ESG investment[2], and does not claim to be exhaustive. By understanding, we mean an understanding of: 1) the "meaning of ESG investment"; 2) "issues in ESG investment in practice"; and 3) "trends in initiatives to address the above issues".

The ESG Working Group hope that through such understanding, ESG investment will take hold and become established in Japan as a long-term endeavor, and a virtuous circle between "economic activity and the environment" will be continuously created by the markets.

---

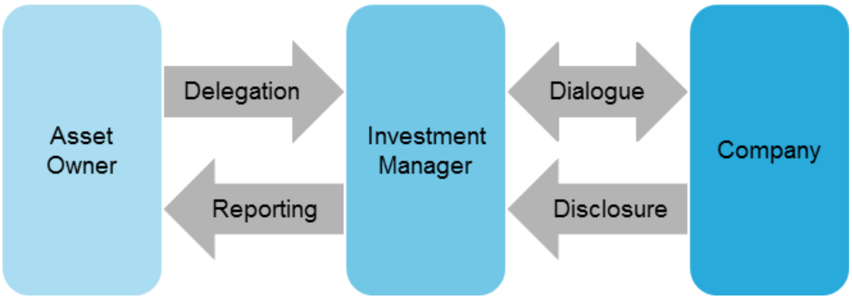
[2] As stated in Japan's Stewardship Code (Guidance 3-3), which of the various factors including non-financial ones (for example, governance, strategy, performance, capital structure, risk management (including how the companies address risk arising from social and environmental matters) of the investee companies) institutional investors should focus upon in particular when working to help achieve their sustainable growth and medium- to long-term increase in corporate value, in order to fulfill their responsibility to enhance the medium- to long-term investment return of clients, may depend on the circumstances of the institutional investor or investee company and thus should be judged by each institutional investor themselves.

Part 1 The Meaning of ESG Investment

Chapter 1 The Investment Chain

In order to understand ESG investment, it is first necessary to establish the entities involved, and here the "investment chain" framework is useful (Chart 1). According to the Final Report of the "Competitiveness and Incentives for Sustainable Growth : Building Favorable Relationships between Companies and Investors" project (otherwise known as the "Ito Review"), published by the Ministry of Economy, Trade and Industry (hereafter "METI") in August 2014, the investment chain can be defined as the "the various paths and processes of capital flowing from its providers down to where companies deploy it towards business activities".

Chart 1 Investment Chain Framework



Based on Kitagawa, *Stewardship and Corporate Governance - Two Codes Changing Corporate, Economy, and Society in Japan*, Toyo Keizai Inc., 2015.

"Asset owners" hold assets such as pension fund assets and provide capital, "investment managers" are mandated the investment management of assets by asset owners, and "companies" deploy this capital; the investment chain comprises at its core these three entities (hereafter "main players").

1) Position of the Main Players in the Investment Chain

(1) Asset Owners[3]

Asset owners, who are the "starting point" of the flow of capital in the investment chain, include a variety of entities such as public and private pension funds, university and church

[3] Outside of Japan, examples exist of asset owners conducting "purposeful dialogue" (engagement) directly with companies, but such examples are rare in Japan. On the other hand, the Government Pension Investment Fund (GPIF) carried out a survey of listed companies for the first time in January 2016 with the objective of evaluating the stewardship activities of its delegatee investment managers and assessing the actuality of "purposeful dialogue" (engagement); meetings continue to be held regularly with companies who answered the survey, as a large number of companies expressed a desire for "meetings with asset owners" in the survey. GPIF also held the first meeting of the "Business and Asset Owner's Forum" in September of the same year, following suggestions from a number of companies for a "forum for the continuous and constructive exchange of opinions between companies and GPIF as an asset owner".

endowments, and life insurance companies. It is important to consider the position in which an entity is placed to interpret its function and role in the investment chain. This will differ depending on whether assets are managed in-house, or investment management is delegated. This is because the way public and private pension funds (who delegate their investment management to trust banks or investment advisers), and insurance companies (who are both asset owners (suppliers of capital) and investment managers) relate - dialogue and engage - with investee companies in the investment chain, differs to a significant extent. On the other hand, notwithstanding differences in the profiles and positions of these entities, both such pension funds and insurance companies are responsible above all else to the final beneficiary and invest for the long-term taking due consideration of risk, the pension funds to secure current and future payments to members and beneficiaries, and insurance companies to make promised payments to their policy holders. On this understanding, while grounded in the "Investment Chain Framework" in Chart 1, this Guidebook is flexible in its treatment of asset owners depending on which issue we believe is important in an introductory commentary to ESG investment.

(2) Investment Managers

Investment managers invest in line with the investment policies and requirements (hereafter "investment policies") set by asset owners, and report investment positions and performance to them. Thus the investment policies set by asset owners are reflected throughout the investment process[4]. Investment managers also deepen their understanding of investee companies through analysis and evaluation of public information and dialogue, in order to manage the assets of asset owners in a sound and efficacious manner for the long-term.

(3) Companies

Securities issued by companies become investment candidates for investment managers[5]. For this reason, to help further proper valuation of their own corporate value, they disclose information about themselves to investment managers, and dialogue with them based on this information.

2) Importance of "Investment Time Horizon" and "Nodes"

The investment chain is stimulated through the purposeful exchange of meaningful information on the part of the main players. Therefore, the "nodes" where asset owners,

---

[4] For example, a "Basic Investment Policy" sets out policies regarding a pension fund's overall asset management framework for the fund to proactively manage its investments, and the "Investment Guidelines" assigns the roles of each investment manager and instructs items that should be complied with, based on the Basic Investment Policy. Investment managers must follow the basic policy and investment guidelines set by the pension fund.

[5] Public organisations may sometimes also become investment candidates for investment managers (eg green bonds issued by public entities). However, as this Guidebook principally aims to understand ESG investment from the perspective of how it pertains to the "sustainable growth of companies," they are not included as a main player.

investment managers and companies conduct the exchange of meaningful information, are an extremely important element when thinking about the economic value the chain is able to create. The sharing of “investment time horizon” is a key factor for the enrichment of these nodes; as the time horizon of all players merge, true communication become possible. The scope and depth of information that should be considered may differ considerably depending on whether the investment time horizon assumed is for example five years or one, and friction in communication between players likely from the inconsistencies in thinking on time horizon.

Asset owners and investment managers need to be well aware of the time horizon they assume, and with that awareness if there are improvements and enhancements that ought to be made in investment policies or dialogue, they should be considered in an organised and coordinated fashion to increase the probability they are realised. It is important that investment managers explain their thinking regarding their investment time horizon, and the information needs and questions arising from this, to companies in an easy to understand way, and work creatively to effectively draw an understanding of their approach to investment from companies. Companies need to disclose information and engage in dialogue with the best time horizon in mind with which to be analysed and evaluated by investment managers, given likely changes in the external environment in which their industry is placed, from the point of view of obtaining financing efficiently and producing sustainable growth.

The main players sharing with each other their line of vision towards the future vis a vis time horizons in this way, conscientiously providing each other with information to further the other’s understanding, and engaging in dialogue with integrity, should help promote mutual understanding of the specific needs and circumstances of each player. This sort of progress in mutual understanding should act as an impetus to increase trust. If the investment chain is a social framework for the creation of economic value, 1) communication of time horizons between asset owners, investment managers and companies, 2) richer dialogue at nodes, and 3) the building of trust through the above, must be essential to maximise its effectiveness.

Chapter 2　Conceptualisation of ESG Investment

1)　Importance of Non-financial Information

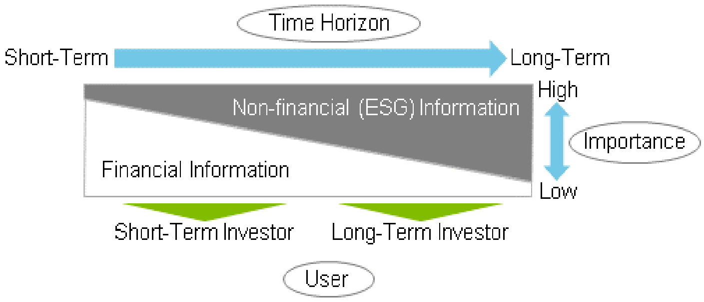
A balanced sensibility towards “risk” and “opportunity” regarding business is important for companies to grow sustainably, but qualitative information on these points derives to a large extent from “non-financial information” that cannot be read from financial information based on balance sheets and profit and loss statements. For example, risk management and R&D related to business risk from environmental issues (information on E), human resources management and training to effectively support these (information on

S), and management policies to strategically implement corporate management including the above (information on G), would be categorised as non-financial information[6]. When analysing and evaluating the process whereby ESG related initiatives come together to produce synergies and act as a driver of corporate growth, non-financial information can also provide valuable perspectives and help produce insights that cannot be gained from financial information alone.

To be able to help companies to achieve sustainable growth, long-term investors need in any case to be resourceful in working to as far as possible accurately identify risk factors, sources of economic value creation and growth paths, and arrive at a real picture of the company and draw a useful picture of its future. For example, if it took ten years for a company to successfully develop and market a product after embarking on research based on an issue they saw as important, the company would be unlikely to see an investor who looked only at the financial information that resulted from the "strength of their management ability" and did not take this non-financial information into consideration, as a "trusted partner who truly understood them". With the enrichment of investment chain nodes also in mind, it is vital that long-term investors have a strong awareness of the significance of non-financial information that can be the source of a company's financial information, deepen their analysis to gain a total understanding of the firm and carry this into a genuine evaluation.

The relative importance of non-financial information changes with the investment time horizon. It can be said that generally, the shorter the time horizon the more important recent "financial information" is, and the longer the time horizon the more important becomes "non-financial information" that cannot be explained by financial information alone (Chart 2).

Chart 2 Relationship between Investment Time Horizon and Non-financial Information



Reference:
Iguchi, "*Information Disclosure to Depict Image of Corporate Value Improvement", Stewardship and Corporate Governance - Two Codes Changing Corporate, Economy, and Society in Japan,* Part 5 p113. Edited by Kitagawa, Toyo Keizai Inc., 2015.

[6] For simplification, this Guidebook regards ESG information as the set of information comprising non-financial information. Other interpretations exist. For example the Law Commission in the UK believes that a clear distinction should be made between financial and non-financial elements in the relationship between ESG information and investment performance. Specifically, material elements that impact investment performance are seen as "financial" factors regardless of whether they relate to ESG information, and information that does not but in some way motivates investment decisions are seen as "non-financial" factors. Refer to Department for Work and Pensions, *Consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'*, 2015, for details.

From the above it can be seen that as long-term investors, asset owners and investment managers are in a position where they should understand well how crucial it is for the medium- to long-term growth of corporate value, to take appropriate consideration of non-financial information in the investment analysis and decision making process.

2) Non-financial Information and Corporate Value

ESG investment is a concept that has rapidly started to be accepted recently, under the leadership of the UN, by the world's institutional investors including asset owners such as pension funds, underpinned by a strong sense of crisis regarding the sustainability of society, the economy and the environment (see Part 2). Difficulties in procuring raw materials due to global warming, friction in trade and increased social unrest from a lack of food, social discontent and the outbreak of conflict arising from various issues stemming from inequality, refugees...all these risks are negative for the sustainable growth of the overall economy. As these risks become increasingly more serious, with the globalisation and digitalisation of the economy, should they be realised, the impact will be very quickly recognised by the equity markets and reflected in the currency markets, and as a consequence also affect economic activity in Japan. This is not hard to imagine if you look at the UK's exit from the EU, for example. It can even be said that it is a requirement of this era to be more sensitive in every industry to such non-financial, qualitative information. ESG investment can provide the main players in the investment chain a perspective that links the above various risk information that would be considered if a medium- to long-term viewpoint is held, with the sustainable growth of companies, and help increase sensitivity to non-financial information.

Furthermore, if a risk is recognised, and the impact of the realisation of that risk can be imagined, there is generally an incentive to try to find a solution from a preventative standpoint. ESG investment also encourages long-term investors and companies, through "better recognition of medium- to long-term risk", to work in this way to find solutions. Here long-term investors need to find latent in that non-financial information, relevant information on a company's "ability to manage risk" or "innovate consistently and promote its innovations", or in other words "value that protects or creates a company's growth". This sort of perception is most easily found in private equity investments[7]. In private equity investment, it is easier to implement radical new measures because "ownership and management" of investee firms are integrated. The value of non-financial information such as the "effective use of environmental resources" and "higher motivation of employees" to the growth of companies can be appreciated from case examples such as: a recovery in earnings as a result of a major reduction in spoiled inventory and increased production efficiency, following a fundamental review of the production process and the drive by

[7] Besides equities, ESG elements can be considered in a broad range of investment fields such as fixed income, real estate and infrastructure.

Management for visualisation of relevant information and streamlining of internal reporting lines, triggered by the recognition of "wasteful use of raw materials" due to a lack of awareness of the importance of the environment and governance as a cause of weak business performance; a pickup in soft business performance and increase in net assets after employee turnover showed a sharp improvement, following an analysis of the reasons for the "high turnover risk" that an investee company carried, and a fundamental review of human resources policies. In this way, in ESG investment various information that is often not immediately reflected in financial information, becomes a subject of consideration as a "source of corporate growth" that translates into financial numbers such as sales and profits with the passage of time[8].

[8] The G20 Green Finance Study Group, *G20 Green Finance Synthesis Report,* 2016 refers to Friede, Gunnar, Busch, Timo & Bassen, Alexander, *ESG and financial performance: aggregated evidence from more than 2000 empirical studies,* 2015 as a paper on the performance analysis of ESG investments.

Part 2　Developments in ESG Investment in Japan and Abroad

Chapter 1　Global Developments

1)　Sense of Crisis at the United Nations

The UN Conference on the Human Environment held in Stockholm in 1972 is generally thought to be the first conference by the UN that had "economic growth and environmental issues" as its main theme. The United Nations Environment Programme Finance Initiative (UNEP FI) was set up in 1992, as a successor to the United Nations Environment Programme (UNEP), which was established 20 years earlier as an organisation to implement in practice the Declaration on the Human Environment and Action Plan for the Human Environment adopted at the above UN Conference on the Human Environment. The UNEP FI undertakes initiatives "toward a financial system that integrates economic development and consideration of ESG, in partnership with financial institutions, policy makers and regulators", and under the leadership of the UN this has acted as impetus to significantly progress initiatives to integrate consideration of environmental risks as a role of finance. Later in 2000, the United Nations Global Compact (UNGC) was established with Principles covering the four areas of Human Rights, Labour, Environment and Anti-Corruption, as a "global framework for various entities centred on companies to act as a good member of society by exerting responsible and creative leadership to realise sustainable growth". The UNGC reflects international society's strong desire for business to also be actively involved in global issues such as environmental issues.

Then in 2006 the Principles for Responsible Investment (PRI) was announced, an investor initiative from the UNEP FI and the UNGC in partnership and proposed by the seventh Secretary General of the UN, Kofi Annan. The PRI is a framework that aims to provide support for mainly institutional investors such as pension fund asset owners to understand the impact of ESG issues on investment, and signatories to incorporate ESG factors into investment and decision making as shareholders, and comprises Principles such as "We will incorporate ESG issues into investment analysis and decision-making processes" and "We will seek appropriate disclosure on ESG issues by the entities in which we invest"[9]. As of the end of December 2016, the number of signatories is over 1,600, and the value of investment assets managed by the signatories as a whole exceeds 60 trillion US dollars. The PRI gives "awareness of the importance of ESG issues in finance" as a reason for the increase in the number of signatories, and acceptance by market participants grows year by year. Global market participants' increased awareness of risk regarding the impact of a deterioration in environmental problems on financial and economic activity can be seen from this trend, which has accelerated further following the Paris Agreement mentioned at

---

[9] Information on the PRI can be found on the following website:
https://www.unpri.org/download_report/3847

the beginning. In the same year the Paris Agreement was adopted, the UN also adopted the Sustainable Development Goals (SDGs) comprising 17 Goals and 169 Targets as an action plan for humans, the planet and prosperity, with more than 150 heads of state in attendance[10].

2) Sense of Crisis in the Financial Industry

The rising awareness of risk regarding climate issues has now reached the G20 Finance Ministers and Central Bank Governors Meeting. The G20 released a statement in April 2015 asking the Financial Stability Board (FSB) to "convene public- and private- sector participants to review how the financial sector can take account of climate-related issues". The FSB decided the visualisation of the financial impact of climate related issues was necessary, and in December of the same year while COP21 was in session, announced the establishment of the Task Force on Climate-related Financial Disclosures (TCFD)[11] composed of members such as institutional investors, accounting firms[12], ratings agencies, financial consulting firms, securities exchanges and corporates. The objective of the TCFD was to propose a voluntary information disclosure framework that is consistent, comparable, reliable, clear and efficient.

Mark Carney, Chair of the FSB and Governor of the Bank of England, stated in September of 2015 before the establishment of the TCFD that there were three broad channels through which climate change could affect financial stability: 1) physical risks, 2) liability risks and 3) transition risks[13]. Of these, 1) and 2) both refer to likely economic losses[14] from the realisation of climate change risk; however 3) refers to the financial risks which could result from the process of adjustment towards a lower-carbon economy - the uncertainty surrounding the possible acceleration of reassessment of the value of a large range of assets

---

[10] The SDGs are an action plan to realise a sustainable world, proposed in the "2030 Agenda for Sustainable Development", global targets from 2016 to 2030 adopted by a UN summit in September 2015. Information can be found on the following Ministry of Foreign Affairs website: http://www.mofa.go.jp/policy/oda/page22e_000793.html

[11] The Chair of the TCFD is former New York Mayor Michael R. Bloomberg (founder, Bloomberg LP), and the Special Advisor to the Chair is former SEC Chair Mary L. Schapiro. The TCFD website can be found at the following:
https://www.fsb-tcfd.org/

[12] The so called "Big Four" accounting firms (Deloitte Touche Tohmatsu, Ernst & Young, KPMG, PricewaterhouseCoopers) are active members.

[13] Carney, Mark, *Breaking the tragedy of the horizon - climate change and financial stability*, 2015; Speech at Lloyd's of London, 29 September 2015 and Batten, Sandra, Sowerbutts, Rhiannon and Tanaka, Misa, *Bank of England Staff Working Paper No. 603: Let's talk about the weather: the impact of climate change on central banks,* 2016 discuss the potential impact of the realisation of climate change risk due to global warming on central bank policy, while also referring to the risks involved in the transition to a low carbon economy.

[14] While a number of papers exist on the subject of the relationship between climate change risk and economic losses, this Guidebook suggests the "Stern Review on the Economics of Climate Change" released in October 2006 as representative. A summary in Japanese can be found on the following MOE website:
http://www.env.go.jp/press/files/jp/9176.pdf

due to policy changes - and with recognition of this risk, recently cases where institutional investors have changed their investment behaviour have been increasing.

At working groups towards the achievement of the 2 degrees C goal, the Intergovernmental Panel on Climate Change (IPCC) and the International Energy Agency (IEA) have considered the total allowable limit for worldwide carbon dioxide emissions and use of carbon resources. They employ the concept of a "carbon budget", meaning the scope of usable carbon resources, and state the view that in order to achieve the 2 degrees C goal, not all the confirmed fossil resources such as coal and oil can be burned – the usable scope could possibly be a third to a fifth[15].

It is possible to draw a risk scenario where given the restrictions of the "carbon budget", in the medium- to long-term there exists a significant amount of fossil resources that will inevitably become bad assets ("stranded assets")[16], and the continued ownership of such resources will lead to writedowns due to revaluation of asset values and damage the balance sheets of a large number of companies. Repercussions and impact throughout the economy are feared should such risk ever be realised[17].

A number of large institutional investors have set forth "divestment" policies; the selling of fossil fuel related stocks or exit from investment into such names, on the back of the long-term goals of the Paris Agreement and scientific opinion of the IPCC behind these[18]. The investor organisation, the Investor Network on Climate Risk (INCR), and others have also worked together with the UNEP FI and the PRI to release statements demanding governments strengthen policy to accelerate investment to ease climate change[19]. Such developments reflecting the higher risk awareness of market participants to global warming also extend to initiatives and studies regarding the disclosure of non-financial information

---

[15] Refer to IPCC, *IPCC Fifth Assessment Report*, 2014, Lima Climate Action High Level Session, Lima, Perú, ; IEA, *WORLD ENERGY OUTLOOK 2012,* 2012 ; and Carbon Tracker Initiative, *Unburnable Carbon - Are the world's financial markets carrying a carbon bubble?,* 2011.

[16] For example Citigroup estimates potential stranded assets in the achievement of the 2 degrees C goal at approximately 200 trillion US dollars. Refer to Citi GPS: Global Perspectives & Solutions, *ENERGY DARWINISM II,* 2015 for details. HSBC points to the importance of managing stranded asset risk from the perspective of investors. Refer to HSBC Global Research, *Stranded assets: what next?,* 2015 and *Investors: Divest or Hold and engage?,* 2015 for details.

[17] Refer to Fulton, Mark & Weber, Christopher, *CARBON ASSET RISK: DISCUSSION FRAMEWORK*, WRI and UNEP-FI Portfolio Carbon Initiative, 2015 on carbon asset risk. Kozuma, Yoshinao, "Impairment Risk Information of Carbon Bubble", *Accounting : Volume 188, No. 1*, 2015 references the relationship between stranded assets and the systemic risks of financial markets.

[18] The Japan Research Institute, Limited, *Research Report about Financial Stability and Climate Change,* 2016.

[19] AIGCC, IGCC, IIGCC, INCR, PRI and UNEP FI, *2014/2015 Global Investor Statement on Climate Change,* 2014. The Global Investor Coalition on Climate Change (GIC) also issued a letter to the leaders of the G20 countries recommending them to "Complete your process for joining/ratifying the Paris agreement in 2016". The letter can be found on the following website: http://globalinvestorcoalition.org/wp-content/uploads/2016/08/FinalWebInvestorG20Letter24Aug1223pm.pdf

and ESG information. Work towards the sustainability of society, the economy and the environment is already being done at various organisations such as securities exchanges in the EU and globally, the International Corporate Governance Network (ICGN), the International Integrated Reporting Council (IIRC), the Sustainability Standards Accounting Board (SASB), the Global Reporting Initiative (GRI), the Carbon Disclosure Project (CDP), the Montreal Carbon Pledge (MCP), the Portfolio Decarbonization Coalition (PDC), the Natural Capital Declaration (NCD)[20], the Natural Capital Coalition (NCC) and the Sustainable Stock Exchanges (SSE). Further, financial information service providers and ratings agencies are increasingly giving more emphasis to non-financial information as part of their efforts to improve their services. It is vital that investors and companies gather information with a firm medium- to long-term perspective to avoid the risk they "miss" these global trends and developments and are "left behind".

In the US, in October 2015 the Department of Labor released the Interpretive Bulletin 2015-01[21] to clarify the relationship between pension investment and ESG factors, as past interpretation of the Employee Retirement Income Security Act (ERISA) may have unduly discouraged the consideration of ESG factors in investment strategies. ERISA is a federal law enacted in 1974 that regulates in an integrated manner the design and operation of corporate pension plans, and has as its sole objective the interests of the plan's participants and beneficiaries, the employees who are investors in the plan, in their retirement income. The revised guidance stated that factors that potentially influence the risk and return of pension investment should be appropriately considered, and ESG was such a factor that could have a direct relationship with the economic value of a plan's investments, and a proper component of the primary analysis of the economic merits of competing investment choices. Further, on the basis that fiduciary duty towards pension scheme members was fulfilled and the most economically optimal investment selected, ERISA did not prohibit the incorporation of ESG factors into investment policy. The clarification that taking ESG into consideration in investment as a factor that impacts the performance of a pension plan's investments, does "not constitute" considering the interests of parties other than the beneficiaries should be noted.

The global trend for ESG elements to be incorporated in the flow of capital in the investment chain, can be read from such developments.

[20] The NCD underwent a name change from the Natural Capital Declaration to the Natural Capital Finance Alliance in October 2016. A summary in Japanese on natural capital can be found on the following MOE website.
https://www.env.go.jp/policy/hakusyo/zu/h26/html/hj14010304.html

[21] US Department of Labor, *Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments,* 2015.

Chapter 2 Developments in Japan

In Japan, as part of the growth strategy under the Japan Revitalization Strategy, the "Council of Experts on the Stewardship Code" of which the Financial Services Agency (FSA) acted as secretariat released Japan's Stewardship Code in February 2014; the METI published the Ito Review in August of the same year; and the "Council of Experts Concerning the Corporate Governance Code" of which the FSA and the Tokyo Stock Exchange, Inc. acted as joint secretariat released the "Final Proposal of the Corporate Governance Code" in March 2015 (taking effect in June the same year). Statements on ESG (excerpted) such as the following can be found in the Ito Review and the respective Codes, as follows:

	Statements on ESG
Ito Review	✓ Investors should clearly communicate the type of mid/long-term, non-financial information they need, and companies should communicate corporate strategy, risk information, governance, and ESG activities while connecting these key issues to financial metrics such as cost of capital and investment returns. This would help to promote the management literacy of Japanese companies. (p28) ✓ Another important issue for dialogue and engagement is non-financial matters such as ESG issues. There is great meaning in striving to attain mutual understanding with respect to these matters. (p29) ✓ ESG (environment, society and governance) is connected to the trustworthiness of companies. Corporate value can be regarded as the manifestation of the level of trust by stakeholders. Therefore activities to improve trust lead to corporate value creation. (p41) ✓ When evaluating the sustainable competitiveness of companies, investors should also focus on ESG activities of such companies. (p41)
Japan's Stewardship Code	✓ Institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the sustainable growth of the companies. (Principle 3) ✓ When investors monitor investee companies, a variety of factors, including non-financial ones, may be considered as relevant. Factors may include, for example, governance, strategy, performance, capital structure, and risk management (including how the companies address

	Statements on ESG
	risks arising from social and environmental matters) of the investee companies. Relevance of a factor may depend on each investor's investment policy and may differ according to specific investee companies. Institutional investors need to use their own judgment in choosing which factors to focus on in light of their stewardship responsibilities. They should endeavor to identify at an early stage issues that may result in a material loss in the value of investee companies. (Guidance 3-3)
Japan's Corporate Governance Code	✓ Companies have a variety of important stakeholders besides shareholders (...) Companies should fully recognize that appropriate cooperation with these stakeholders is indispensable in achieving sustainable growth and increasing corporate value over the mid- to long-term. Given the recent and growing interest in social and environmental problems worldwide, taking positive and proactive measures toward ESG (environmental, social and governance) matters may also be included as part of this cooperation. (General Principle 2 (Notes)) ✓ The appropriate actions of companies based on the recognition of their stakeholder responsibilities will benefit the entire economy and society, which will in turn contribute to producing further benefits to companies, thereby creating a virtuous cycle. (General Principle 2 (Notes)) ✓ Companies should take appropriate measures to address sustainability issues, including social and environmental matters. (Principle 2.3) ✓ With the recognition that dealing with sustainability issues is an important element of risk management, the board should take appropriate actions to this end. Given the increasing demand and interest with respect to sustainability issues in recent years, the board should consider addressing these matters positively and proactively. (Supplementary Principle 2.3.1) ✓ Companies should appropriately make information

	Statements on ESG
	disclosure in compliance with the relevant laws and regulations, but should also strive to actively provide information beyond that required by law. This includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and business issues, risk and governance. (General Principle 3) The board should recognize that disclosed information will serve as the basis for constructive dialogue with shareholders, and therefore ensure that such information, particularly non-financial information, is accurate, clear and useful. (General Principle 3)

Elsewhere, the Government made the following Cabinet decisions on policies on ESG initiatives (excerpted) over a period from May to June of 2016.

	Policies on ESG
The Plan for Global Warming Countermeasures (May 2016)	✓ Undertake initiatives to promote from the perspective of finance, environmentally friendly behaviour that contributes to the reduction of greenhouse emission gases such as environmentally rated loans, ESG investment that considers the Environment, Social and Governance, public disclosure of ESG policies by institutional investors, incentivising environmentally friendly behaviour by evaluating investee company activity from both financial and environmental perspectives, and reflecting the result in investment and financing activity. (p52 of the Japanese language document)
Basic Policy on Economic Management and Reform 2016 (June 2016)	✓ To put the Japanese economy on a sustainable growth track, it is necessary to encourage companies to put their retained funds into investments. It is also important to strengthen the medium- and long-term abilities of companies to grow and generate profits by taking actions including making investments in ESG (environment, society and governance), human resources, R&D and other intangible assets, and by efforts to improve their capital efficiency. To this end, the government will

	Policies on ESG
	cooperate with exchange and other related parties to improve the viability of corporate governance. Specific measures will also be discussed for enhancing dialog between companies and investors. (p18)
Japan Revitalization Strategy 2016 (June 2016)	✓ Study not only the promotion of ESG investment, but corporate management and investment that produce sustainable corporate value and methods of evaluation thereof; governance mechanisms, management investment decisions, investor evaluation thereof and information disclosure, that encourage optimisation of investment in human, intellectual, manufacturing and other capital, and produce a conclusion before the end of the fiscal year on policy action to encourage optimisation of investment. (pp147-148 of the Japanese language document) ✓ Given the growth in views giving importance to ESG factors in making investment decisions, and the increasing number of institutional investors taking a step further and signing the UN Principles for Responsible Investment, encourage active progress in dialogue between companies and investors towards the strengthening of medium- to long-term growth and profitability. (p151 of the Japanese language document) ✓ At pension funds, enhance the retirement income of members through initiatives to increase the effectiveness of corporate governance, such as promotion of acceptance of the Stewardship Code. (p162 of the Japanese language document)

In September of 2015 the Government Pension Investment Fund (GPIF), with the world's largest pension assets, signed the PRI[22]. When signing, GPIF released "Our Basic Perspective on ESG Issues", and stated that it was strengthening GPIF's commitment to

[22] Following the signature of the PRI by GPIF, the number of institutional investors signing the PRI in Japan is accelerating, with the Pension Fund Association (PFA) signing in May 2016 among pension funds.

ESG issues as part of the fulfillment of its stewardship responsibilities, and that signing the PRI was in order to express its attitudes to ESG issues[23]. Since signing, GPIF has enacted measures to encourage further proactive engagement activity by investment managers towards the "increase in corporate value" and "fostering of sustainable growth" considering ESG, and in July 2016 released the "Call for Applications for ESG Index for Japanese Equities". In this, GPIF makes clear the meaning of considering ESG factors in investment as follows.

"Call for Applications for ESG Index for Japanese Equities" (excerpt) It makes sense for GPIF - a universal owner[24] with a massive portfolio - to try and maximize long-term investment returns through minimizing negative externalities related to environmental and social issues. Furthermore, GPIF expects that considering ESG factors should improve risk-adjusted returns by mitigating risk over a long period.

Initiatives are also progressing with respect to equity indexes that take ESG factors into consideration. The Tokyo Stock Exchange, Inc. calculates and releases a number of jointly developed indexes with other firms, and the Bank of Japan decided in December 2015 to purchase ETFs composed of stocks issued by firms that are proactively making investment in physical and human capital[25]. The ETF adoption criteria here include besides a proactive stance towards investment in human resources, elements of appropriate corporate governance.

In this way, while awareness of the consideration of ESG information is rising in Japan, it looks like that for many players in the investment chain, it still remains an "issue that needs to be addressed". It is also hard to say that it is understood in sufficient depth about what constitutes ESG information or investment that will contribute to the sustainable growth and medium- to long-term enhancement of corporate value. Compared to Europe and the US, it is only relatively recently that these initiatives have started to be undertaken seriously, and it is to be hoped that for the market to grow and mature in a healthy way going forward, more players in the investment chain acquire appropriate knowledge and understanding of ESG, and gain real competency.

---

[23] GPIF, *GPIF has become a signatory to the UN-PRI,* 2015.

[24] GPIF introduces its thinking on universal ownership in materials distributed by the Study Group on Long-term Investment (Investment evaluating ESG Factors and Intangible Assets) toward Sustainable Growth, established by the METI in August 2016. The materials can be found in Japanese on the following METI website:
http://www.meti.go.jp/committee/kenkyukai/sansei/jizokuteki_esg/pdf/001_07_00.pdf

[25] Bank of Japan, *Statement on Monetary Policy (Introduction of Supplementary Measures for Quantitative and Qualitative Monetary Easing),* 2015.

Part 3 Issues Regarding ESG Investment in Practice and Trends in Initiatives to Address Them

Various issues exist across multiple areas towards ESG investment in practice. That the main players overcome these issues one by one and gain real capability is imperative for the investment chain to work effectively as a network. At the same time, the behavioural guidelines and rules of each player, or management resources such as people, goods and money are obviously various. For ESG investment to properly take hold and become established in Japan as a long-term endeavour, it is important for each player to institutionally and proactively make flexible judgments and modifications in line with their own circumstances while considering feasibility and effectiveness. Here, with the above in mind, we introduce issues regarding the advanced practice of ESG investment and trends in initiatives to address them in a factual manner, with the help of the use of cases both in Japan and abroad.

Chapter 1 Asset Owners

1) Better Understanding of the Investment Chain

As long-term investors, asset owners need to understand that they are in a position where they could impact the investment chain, and thus the capital markets, through their investment policies. This fundamental understanding offers prospect for practical initiatives to address the issues below.

2) Better Dialogue with Investment Managers

Looking at the flow of capital in the investment chain, dialogue at the node between asset owners and investment managers first becomes important. If the investment time horizon is properly shared between asset owners and investment managers, this should facilitate mutual understanding of the importance of non-financial information, and the sharing of perspectives and thinking on risk and return. On the basis of such a solid relationship, on the part of asset owners it is vital they properly understand why Japan's Stewardship Code and the PRI are necessary for investment managers and be able to explain clearly what they expect from investment managers. On the part of investment managers, given Japan's Stewardship Code and Japan's Corporate Governance Code (hereafter the "two Codes"), it is vital that they work to strengthen their dialogue ability to help the sustainable growth of companies so that they may properly meet the expectations of the asset owner. The mutual sharing in understanding of the individual initiatives of investment managers regarding ESG issues - for example, initiatives to introduce a framework to consider ESG elements into the traditional investment and decision making process based on financial information, and thereby to enhance investment and risk management systems and processes (hereafter "ESG integration")[26] - is crucial for the enhancement of dialogue. Asset owners need to understand

[26] Besides "ESG integration", ESG investment strategies are normally grouped into the seven

that proactively trying to understand the thinking and initiatives of the investment manager regarding ESG and cultivating a constructive relationship means their behaviour also encourages the "consideration of diverse risks" leading to the securement of medium- to long-term investment return or in other words the profits of the final beneficiary.

3) More Effective Management and Supervision of Investment Managers

If asset owners add work on initiatives regarding stewardship responsibilities and ESG investment to rating criteria items when selecting and contracting with investment managers, this should further encourage a positive stance from investment managers to these initiatives. In order to ensure the proper management of delegated investment managers, requesting investment managers report regularly on their record (for example on engagement and proxy voting) to help the sustainable growth of investee companies and creating a mechanism to link this to their evaluation of delegatees, proactively sharpening their own critical questioning skills regarding ESG and aiming to monitor investment managers effectively, are all extremely important in helping to encourage the improvement of the investment and risk management systems and processes of investment managers. A more substantial perspective asking not only the final results of the process such as the "number of dialogues conducted related to ESG" or the "resulting return", but also the "nature of the dialogue and the expected impact" or the "analysis and evaluation of the circumstances behind the return and its sustainability", is important in ensuring the effectiveness of the initiatives.

4) Greater Specialist Expertise as a Long-Term Investor

In this way through appropriate evaluation and monitoring of the initiatives of investment managers, asset owners are able to encourage such initiatives. Such encouragement should support the medium- to long-term investment behaviour of investment managers and also help to improve dialogue with companies who strive for sustainable growth. It is expected therefore as a result to contribute to the construction of a portfolio with low volatility and resistant to downside risk, and to the securement of stable risk-adjusted medium- to long-term return. However, to put this into practice, asset owners need to continue to educate themselves and to increase their expertise and knowledge of investment management. Such work should lead to not only better monitoring, but also a better "eye" or judgment in the selection of investment managers, and thus is extremely important. So that asset owners continually develop their skills, it may be helpful to establish a framework to incentivise such initiatives in an organised and effective manner. Policies to train investment management

---

categories of negative screening, positive screening/best-in-class, international norms-based screening, sustainability-themed investment, impact investment, and corporate engagement/shareholder action. Refer to Chapter 1 of Nikko Research Center, *Report on Surveys about Visualization of Status of Women's Active Work in Capital Market in FY2015,* 2016 and *Status of Utilization of Non-financial Information Focusing on Women's Active Work for Investment,* 2016 commissioned by the Cabinet Office. The report can be found in Japanese on the following Cabinet Office website:
http://www.gender.go.jp/policy/mieruka/company/27mierukachosa.html

specialists for the long-term and to properly allocate such people should also lead to a stronger architecture with specialist expertise.

5) Improvement and Enhancement of Investment Policy

We would like to note again with respect to the initiatives above, the importance of asset owners fully understanding the place of investment management as long-term investment in the context of the investment chain framework. For this, a broad perspective and flexible mindset, not limited to "short term movements in risk and return based on financial information", are required. Indeed, these are qualities that long-term investors are expected to possess in any case. Given the certain progress in thinking regarding ESG factors and a rising international sense of crisis regarding the relationship between global issues and financial and economic activity, as can be intimated from increased long-term uncertainty as symbolised by the Paris Agreement and the revised guidance of the ERISA Interpretive Bulletin, whether managing assets for the long- and super-long-term based on an understanding of risk and return that does not proactively consider ESG information can really be said to be a legitimate process doing the best possible for the protection of the beneficiaries, is an important question in the fulfillment of an asset owner's fiduciary duty. Therefore the ability to act is required of asset owners to consider institutionally such a question, and to look to improve and enhance investment policy if necessary. It can surely be said that, given the rising sense of international crisis above, it is expected of institutional investors to clearly show themselves to be working to be a "responsible investor".

Chapter 2 Investment Managers

1) Richer Dialogue with Companies

For investment managers to achieve reliable and superior investment performance, investee companies need to manage risk appropriately and to produce economic profits consistently. In order to assess the sustainability of this profit, investment managers need to improve their knowledge and understanding of non-financial information regarding the company's business model and changes in the business environment, and management strategy addressing these. To do this, a process of drawing out from the company elements that are important in making an across the organisation assessment and evaluation, by effectively piecing together major management policies and functions of relevant divisions such as the agenda and initiative setting process for the Board of Directors, organisational lines of communication and management of policy measures, is essential. Here it is vital that investment managers prepare fully to properly express to the company their fundamental stance to develop an in depth understanding of the whole company as a long-term investor, and gain the company's trust as a "medium- to long-term partner". The investment manager's attitude to dialogue is also important. For example, if there is still an implicit assumption of a division of roles where the "investment manager asks the questions" and "the company answers them" and if it is hard to find a relationship where they learn from each other from flexible dialogue, then realistically it is difficult to expect a constructive and creative process that is based on a shared sentiment by both to discover new corporate value together.

2) Enhancement of Dialogue with Asset Owners

The role of investment managers as specialists in asset management is to gather and analyse various information about companies, and to develop an in depth understanding of corporate value. Therefore they are in a position to explain to asset owners who do not have the opportunity to dialogue with companies, the importance of non-financial information as a source of economic profits, and thinking on investment risk and return based on a medium- to long-term view. This sort of work is not only useful for the investment manager in sharing its medium- to long-term investment time horizon with asset owners, but should also help in gaining the asset owner's understanding towards its own initiatives such as "ESG integration" to improve investment and risk management systems and processes. When dealing with specialist matters such as "ESG integration", it is necessary to understand the other's vantage point, and conscientiously explain how ESG elements are incorporated in the investment process using tools such as simple diagrams. In addition, relating various new initiatives being seen in the investment chain to the asset owner, such as those being undertaken under the two Codes (for example engagement and proxy voting), and explaining why these should in consequence help the consistency and improvement of investment performance, should help stimulate the asset owner's awareness of the "interconnectedness" of the investment chain.

3) Leadership of Management

The enhancement of dialogue above should be helpful for smooth communication with both companies and asset owners, and useful for the mutual understanding of the main players centring on investment managers. However, for these efforts to be sustained, there are limits if only a few fund managers and analysts act on their own. It is vital that after Management at the asset manager first makes clear their stance as long-term investors, the debate and organisation of the points at issue in improving investment and risk management systems and processes for long-term investment should be set as a management goal, for example the validation of "ESG integration", allocation of necessary management resources, establishment of research and human resource development infrastructure, alliance with an external specialist ESG research organisation, and signature of the PRI. Besides the two Codes, looking at the direction of global trends in long-term investment, the raising of sensitivity to the non-financial information of companies, and of inclusiveness and absorption through these initiatives should become a source of competitiveness as an investment manager.

4) Sharing Issues as the Investment Management Industry as a Whole

If investment managers are able to find risks and opportunities from global issues such as global warming that impact financial and economic activity, and incorporate these appropriately into the investment analysis and decision making process, it becomes possible to help avoid or limit the decline of medium- to long-term performance. The decision whether to do this proactively rests largely in the first instance on one's thinking on how important higher "accountability to stakeholders" is; and the position of long-term investors is such that they should do so. On the other hand, due to the nature of the information involved, ESG elements do not necessarily suit quantitative analysis based on financial information. For this reason, it is possible that for those who look at economic profits from a short term perspective, ESG investment seems to be "odd and hard to comprehend", and that they understand it superficially as "selective investment whose objective is to make society a better place".

With the existence of such various different positions and differences in opinion, whether ESG investment becomes established depends to some extent on how the investment management industry evaluates companies undertaking meaningful initiatives for the sustainability of society and the economy from the point of view of the medium- to long-term growth of corporate value. It is also strongly desired that the investment management industry proactively studies and develops its thinking, criteria and methods for companies to be fairly evaluated by the markets, to make its approach to the "sources of company growth" a richer one from the standpoint of the industry's own sustainable growth. Initiatives to strategically use non-financial information along with financial information are imperatives for the market function to be properly effective towards the sustainable growth of the economy overall. The consideration of ESG information in the medium- to long-term evaluation of corporate value allows analysis incorporating much more information than in the analysis and evaluation of companies using financial information alone, and so investment decisions judging diverse risks. Investment managers must have a fresh awareness of their responsibility as an investment management specialist to acquire such investment judgment and to realise sustainable return growth for beneficiaries from a medium- to long-term point of view.

Chapter 3 Companies

1) Richer Dialogue with Investment Managers

Investment managers gather information helpful in making investment decisions on companies from information disclosed by companies and their dialogue with them, and analyse and evaluate this. Asymmetry in information still remains between companies and investment managers even with such work. Companies need to proactively disclose sufficient information in terms of both quality and quantity, and be eager to augment and encourage investment managers' understanding of the company so that they are properly rated and valued. Furthermore, hard work and creativity to effectively draw understanding of their initiatives towards their own sustainable growth from their counterparty and to encourage an in depth understanding of themselves – "purposeful dialogue" (engagement) by companies with investment managers – are wanted. It is important with dialogue with overseas institutional investors in particular, to strategically deepen mutual understanding as necessary in order to resolve asymmetries with respect to information peculiar to Japan (for example history behind rules and institutions relevant to a company, corporate culture, business practices, and geological characteristics due to frequent seismic activity).

2) Measures to Help Improve Dialogue Ability

Unlike financial information, which is expressed quantitatively with generally accepted rules and definitions, so allowing a common understanding to be easily established, the cooperation of various related parties transcending individual divisions is necessary to objectively evaluate varied non-financial information, tying it to corporate value, and to furthermore share perspectives and thinking regarding sustainable growth with investment managers. For example, it is difficult for the Investor Relations division alone to deal with, if in dialogue an investment manager asks questions like "your views on the economic impact of improved waste disposal and recycling systems and processes", and "the impact and issues regarding a change in the age distribution of employees and company activities". Going forward, with the importance of non-financial information likely to increase in the evaluation of corporate value and the number of questions on ESG expected to grow, it would be good for the CSR division to sit in on dialogues and to provide and enhance institutional support so that "one stop" explanation is possible. Synergies should be produced through explanation by different divisions from different viewpoints with their differing roles, and the investment manager's understanding of the company made significantly deeper. Dialogue ability as an organisation should also be improved with more employees in different divisions able to join dialogues, and mutual understanding of the perspectives and understanding of issues of investment managers be furthered. Stronger sales and the reduction of information costs can also be expected as a result of better dialogue ability.

3) Leadership of Management

With respect to dialogue with investment managers, companies should make clear their agenda in terms of "what they want them to understand, or further their understanding", and determine a focus for communication. To do this, the creation of a reporting line is necessary that draws up through the organisation analysis and evaluation of non-financial information in addition to financial information, to ensure Management are able to understand the current state and draw an accurate future picture of their company. Action is also needed from Management to consider and understand the value that investor relations activities can bring to their company, to instruct relevant divisions to research "effective methods of information disclosure and dialogue", and to review if necessary in a flexible manner organisational structure and the flow of information and people between divisions. The relevant divisions should not only study the information disclosure and dialogue initiatives of companies in both Japan and abroad and trends in disclosure of non-financial information, but also provide Management with the information that each division believes to be important and encourage new insights. It can be easily imagined that companies where various such initiatives are undertaken as an organisation, and Management and the relevant divisions work well together as the "two wheels of a cart," have a clear sense of the direction they should take as an organisation and have an advantage relative to other companies with respect to disclosure and dialogue. Such firms are also more likely to be noticed by investment managers, facilitating the building of constructive relationships.

4) Increased Management Sensitivity to Issues of Global Significance and the Role and Duties of the Board of Directors

Management need to maintain an interest in global developments regarding the disclosure of non-financial information, and through dialogue with investment managers, to gain a deeper understanding of market participants' sense of urgency behind these. Because companies whose Management have limited sensitivity to these issues tend to be organisations with limited consciousness of being involved as an interested party with respect to ESG issues, they are likely to find it even more difficult going forward to be rated highly by long-term investors. Such companies with limited sensitivity face the risk that they undertake capital expenditure projects based on a mistaken medium- to long-term outlook, are behind the curve on new regulatory trends and are forced to later recall products, or fail to capture new business opportunities produced by these globally significant issues. With long-term investors likely to demand far higher Management sensitivity to global issues, it is extremely important the Board of Directors support Management decisions based on long-term thinking with respect to strategic management issues regarding sustainability.

5) Appropriate Communication Between a Company and its Pension Fund

In Japan, companies reflect the performance of their pension funds on their own balance sheets based on the accounting rules for retirement benefit plans. Pension fund assets are valued at the end of every period, and future benefit payments to beneficiaries are recorded as a retirement benefit liability. Should assets and liabilities not balance and for example assets are smaller than liabilities, the difference is reflected on the company's balance sheet as a liability pertaining to retirement benefit obligations. If mistakes are made in pension management, and the smaller pension assets become and the larger retirement benefit liabilities become in turn, this will lead to a decline in net assets. Thus under current accounting standards, because investment performance at a pension fund impacts the finances of its parent company in an immediate and direct way, the company can be said to be in a position where they should hold an interest in the investment policies and risk awareness of its pension fund. In other words, while taking the duty of a pension fund to maximise returns for its final beneficiaries as a given, the parent company not only need to gain a more in depth understanding of the management of the assets of the pension fund, it is also important that they maintain appropriate communication with the pension fund on risk awareness with respect to pension finances and the management of assets, by relating the importance of a medium- to long-term investment time horizon and perspective as one company on the issues towards sustainable growth. ESG investment is also expected in consequence to ease the impact of global issues like global warming and thus benefit the welfare of future employees. It is desirable for the parent company to check the state and effectiveness of their own governance from an overall standpoint including the old age and welfare of its employees, and as part of this for example conduct information exchanges about pension investment with the pension fund.

Part 4 Players Reinforcing and Supporting the Investment Chain

A number of players exist in the investment chain other than the main players. They can be said to reinforce and support the investment chain, forming part of the chain with the main players, influencing each other in a relationship of interdependence and checks and balances. The more constructive relationships form between individual players and produce synergies, the better this chain will be able to perform its function as a social framework to create economic value. The expected roles of these players follow below.

1) Pension Consultants

The role of a pension consultant is to provide various services to pension funds, such as advice regarding the administration and management of pension assets. Therefore by explaining to pension funds the importance of a medium- to long-term perspective in pension investment management, they are in a position to encourage the formation of constructive relationships between pension funds and investment managers who have signed up to Japan's Stewardship Code. The proper rating by pension consultants of work done and results produced related to ESG, such as "ESG integration", by individual investment managers should also provide incentive for investment managers to fulfil their stewardship responsibilities.

2) Sell Side Analysts

The main role of sell side analysts in the research divisions of securities brokers is to provide information to buy side investment managers who trade individual securities issued by companies, to help them in their investment decisions regarding these companies. Sell side analysts can also disseminate their opinion widely to not only domestic institutional investors, but also overseas institutional investors through English translations of their analysis and rating reports of individual securities. For these reasons, the investment decision signals issued by sell side analysts tend to be easily transmitted to the investment chain. Going forward, the importance of non-financial information in the evaluation of corporate value will only rise further, and the need in the investment management industry for investment information related to ESG is likely to increase. If expectations grow with respect to the role of sell side analysts in this regard and sell side analysts actively issue investment signals taking ESG information into consideration, it seems probable that dialogue between the main players will be enhanced.

3) Financial Information Service Providers

The recent rapid development of ESG investment owes much to the evolution of financial information service providers. They support the investment chain by bridging ESG information with the practicalities of the investment process, through not only the creation of databases of huge amounts of information relating to companies both in Japan and abroad, but also increased convenience for data users, enhancement of data processing and analysis and ESG item scoring functions, and an expansion in the product lineup of equity indexes incorporating ESG. Going forward, we look for them to continue to improve the services they provide and refine their frameworks for analysing and evaluating company information and designing products, giving even greater care to distinctions in the particular issues faced by different countries and regions. It is also desirable that investment managers from the point of view of securing stable medium- to long-term investment performance, together with building their "ESG integration" processes, are familiar with these services and seek to improve their investment and risk management systems and processes. With the new ERISA Interpretive Bulletin 2015-01, it seems probable that if investment performance is the same, the numbers of investment managers who prefer financial products that incorporate ESG elements will increase going forward. If so, investment managers can be said to be placing a relatively higher value on companies that contribute to the sustainability of society and the economy, and financial information service providers are in a position to encourage such investment behaviour.

4) Trade Unions

The Japanese Trade Union Confederation (hereafter "JTUC-RENGO") established the "Guidelines on Responsible Investment of Workers' Capital" (hereafter Guidelines) in December 2010 and they were revised in December 2015 [27]. The Guidelines define workers' capital as "funds such as pension funds which have been contributed to by workers and/or contributed to on the behalf of workers" and workers (their trade unions) as the "owners of workers' capital", and encourage workers to be conscious as owners of their responsibilities and rights regarding pension investments. Specifically the Guidelines ask for the practice of "responsible investment" as defined below.

> The term "responsible investment" refers to the incorporation of non-financial factors such as "ESG (environmental, social and corporate governance)" in addition to financial factors into the investment decision making processes and accounts, and the exercise of shareholders' rights.

Real work towards the establishment of the Guidelines can be said to have started in 2008 to 2009 as the impact of the Global Financial Crisis made itself felt. The relationship between money gone wild and workers' capital was debated and the Guidelines give as one of the fundamental principles of investment of workers' capital that "Efforts shall be made to exclude speculative investment and to secure stable mid- and long-term stable returns". The Guidelines see the "responsible investment" above as a means to secure such stable returns. They also set out "Procedures" from the establishment as a trade union of basic policies regarding responsible investment to monitoring after the start of that responsible investment. This initiative by JTUC-RENGO to actively assess the administration and management of workers' capital from the position of final beneficiary as a worker on a medium- to long-term

[27] JTUC-RENGO, *Guidelines on Responsible Investment of Workers' Capital (revised),* 2015.

view taking "responsibility" into consideration, should help strengthen the ability of pension funds to dialogue with investment managers.

5) NPOs etc.

There are various organisations in Japan carrying out activities to promote and disseminate ESG investment, one of which is the NPO Japan Sustainable Investment Forum (JSIF), active for many years since its establishment in October 2001. The JSIF offers players in this field of investment and interested individuals a forum for the interactive exchange of ideas and research with leading experts. It published the "White Paper on Sustainable Investment in Japan 2015" in January 2016, researching and reporting in detail the actuality of this field in Japan[28]. The Global Sustainable Investment Alliance (GSIA) produces a report once every two years on the state of sustainable investment globally with the collaboration of SIFs around the world including JSIF[29]. The JSIF is also an official supporter of the PRI and the NCD[30], a natural capital finance initiative advocated by the UNEP FI. ESG investment could develop further in Japan going forward, and the sort of ESG promotion and education activities undertaken by the JSIF through tie ups with various overseas organisations to relay to Japanese people global information regarding ESG investment and building a sustainable society, and communicate abroad the status in Japan, can be said to be meaningful for further growth in the investment chain.

6) Industry Associations

Principle 7 of Japan's Stewardship Code states the following:

To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

The Principle states "should have the skills", but in order to establish these skills and properly utilise them in the investment analysis and decision making process, it is vital that Management at investment managers give due consideration to practical arrangements and invest real effort. This is really an issue for each individual investment manager, but it can be said to be a positive trend if the investment management industry as a whole shares and records various case studies regarding dialogue, and establishes a framework to support the individual efforts of investment managers. In the investment management industry, as associations exist to which each individual investment manager belongs, in order to increase

[28] JSIF, *White Paper on Sustainable Investment in Japan 2015,* 2015.

[29] Since 2013 the Global Sustainable Investment Alliance (GSIA) has released reports collating studies of sustainable investment in major regions of the world in collaboration with JSIF, US SIF, UKSIF, Eurosif in EU and other regional SIFs. The website can be found at the following: http://www.gsi-alliance.org/

[30] Refer to footnote 20 for the NCD's name change.

the effectiveness of Japan's Stewardship Code it is important for such associations to support initiatives by investment managers, including Principle 7, to improve their dialogue and other skills.

7) Media

The media, including television, newspapers and magazines, play an extremely important role in the formation of public opinion. The proper evaluation and reporting by the media of information on corporate earnings and the investment performance of institutional investors from a medium- to long-term viewpoint, should provide an opportunity for a larger number of related parties to realise the importance of long-term thinking, and in this way enhance the functionality of the investment chain.

8) Government

In recent years a number of government ministries, under their own remit, have been working on initiatives related to the two Codes. The exchange and liaison of information and the sharing of the direction of policy measures among ministries, can be said to have meaning from the point of view of policy effectiveness for the country as a whole.

The MOE has been working on an "Environmental Reporting Platform Development Pilot Project" since FY2013 as a policy measure with a focus on dialogue in the investment chain. This is a project supporting the enhancement of dialogue between companies and investors through the construction of an "environmental reporting system", structuring a database of the environmental information disclosed by companies and incorporating functionality likely to be useful when investors dialogue with companies, such as the ease of access and comparison analysis of data, and is currently being operated on a trial basis[31]. Looking at possible synergies with this policy measure going forward, an example of a major topic to study could be the "systematic organisation of environmental information likely to be useful in dialogue between investors and companies"; debate between related parties on ways to utilise the results of such study in the enhancement of the functionality of the investment chain, would be a desirable development.

The MOE's continued use of the financial industry wide platform "Principles for Financial Action towards a Sustainable Society (Principles for Financial Action for the 21st Century; PFA21)" as a useful environmental policy tool, can be said to be important for the promotion and dissemination of ESG investment. Such continued government support is vital for ESG investment to be appropriately accepted and established in Japan as a long-term endeavour,

---

[31] The MOE placed this project in "pilot phase" in FY2016, aiming to operate a "platform bringing together companies and investors, to produce rich dialogue". During this period, the number of corporate participants has grown from 64 (FY2013) to 206 (FY2015), and the number of financial institution participants has grown from 13 (FY2013) to 95 (FY2015). The number of participants in FY2016 (as at end December) is: corporates 255, financial institutions 159, with both figures higher than in FY2015. The MOE is currently planning to take the platform into full scale operation after a certain period of pilot operation.

in addition to the proactive signature of PFA21 and active engagement with issues surrounding sustainability by a broad range of finance industry parties.

Column: Case Studies Pertaining to "E"

Here, as an aid to furthering the reader's understanding of this Guidebook, we give an introduction to a number of cases pertaining to companies and the "E" in ESG issues based on publicly available information on the internet, in line with the categorisation below.

1. Examples where "E" issues had a major negative impact on company activities
2. Examples where companies have taken steps to avoid the realisation of risks related to "E"
3. Examples where companies have taken an "E" issue as a business opportunity

1. Examples where "E" issues had a major negative impact on company activities

- *Penalty for environmental pollution with an oil spill accident*

An explosion occurred at a drilling rig in the Gulf of Mexico, and as a result large amounts of oil spilled into the ocean. This accident not only had a serious impact on the fishing and tourism industries in the Gulf of Mexico, but also caused major damage to the Gulf's ecosystems. The company responsible for the accident ended up paying 20.8 billion US dollars in penalties. Clean up and litigation costs were also significant.

- *Penalty for inappropriate compliance with exhaust regulations*

A firm embedded illegal software in cars that it manufactured to clear exhaust regulations, and in the US sold several hundred thousand of these cars. The firm incurred significant costs, including a settlement with the owners of its cars for 14.7 billion US dollars.

- *Protests by residents and consumers due to insufficient understanding of finiteness and usage of water resources*

A factory in the Asia region pumped approximately 500 thousand litres of underground water a day to produce soft drinks. Due to this pumping, after a period of time water for drinking and daily use of local residents of the factory dried up and pollution of the water was also found. Faced with this, interested local parties carried out strong protests against the company. As a result, the company was ordered by the court to stop pumping underground water and closed the factory as it was not able to procure raw materials. Furthermore, the protests spread to the company's home country, and in addition to a large number of interested parties gathering in front of the annual shareholders' meeting venue to protest, there were movements in some regions demanding the prohibition of the sale of the firm's products.

2. Examples where companies have taken steps to avoid the realisation of risks related to "E"

- *Preventative management approach based on company's own risk profile*

With the importance of water resources to its own business, the firm established a working group to address issues of deterioration in water quality and water scarcity during droughts. It is working to create strategies to protect water resources, and as part of this has introduced a system to increase efficiency in the usage of water resources at a number of factories, with the objective of stable and sustainable factory operations.

The firm constructed 30 thousand rainwater infiltration trenches in underground water resource regions to provide for water scarcity during drought, with the objective of stable and sustainable operation of factories that use large amounts of water. This should allow an efficient utilisation of rain water that boosts rainwater circulation and effectively secures ground water.

- *Establishment of systems and processes for procurement and management of raw materials, taking supply chain into consideration*

The firm created its own "Lumber procurement guidelines" summarising forest product procurement policies, to fulfill its social responsibility to protect biodiversity and use resources sustainably. These guidelines use the "Responsible Purchasing Checklist for Forest Products"[32] (a "checklist" to connect forests and people) created and released by WWF Japan, to 1) identify the origin forest of the forest product (confirmation of traceability back to place of origin), 2) confirm "appropriateness of forest management operations", and carry out checks in line with 12 criteria giving consideration to economic, environmental and social issues. The firm gives emphasis to the supply chain, aiming to make improvements together with the supplier for forest products with the lowest ratings, but at times declining to buy where it believes improvement is difficult.

3. Examples where "E" issues had a major impact on company activities

- *Initiative to replace old products with new high functioning products*

Solar lanterns (solar powered lamps) are being made available at reasonable prices in areas without electricity in Asia, Africa and other regions. The switch from traditional kerosene lamps to solar lanterns not only reduces the emission of greenhouse gases, but also helps reduce health problems deriving from the kerosene lamps, as well as household expenses without the need to pay for kerosene.

- *Initiatives to utilise existing technology and products to develop new markets*

A firm partnered with regional tea farmers and government to provide across the board its technology and knowhow on tea growing to a tea plantation created by local municipalities and businesses. This also contributed to job creation in the region. Furthermore, the firm studied the effective ingredients contained in used tea leaves and developed its own proprietary recycling system using used tea leaves as a "valuable resource" (the used tea leaves are utilised in items such as tatami mats with deodorising properties and household products with antibacterial properties). The raw materials used in the original product can be reduced by the amount of the used tea leaves included.

- *Initiatives to protect livelihoods from risks and achieve sustainable growth together with the region*

To ease losses during droughts, the firm offers small-scale farmers in Southeast Asia a product that makes a predetermined insurance payment when cumulative precipitation falls below a certain point ("weather index insurance"). The compensation of damage to agricultural produce due to climate change helps farmers maintain self-sufficiency and improve living standards. Through the provision of solutions to social groups vulnerable to risk, the firm aims to both contribute to the realisation of a sustainable society and its own sustainable growth.

[32] Information on the Responsible Purchasing Checklist for Forest Products can be found on the following WWF Japan website:
https://www.wwf.or.jp/activities/2009/09/685514.html

Conclusion

This Guidebook has emphasised the importance of a constructive relationship between the various players in the investment chain and mutual understanding and trust to support this, with institutional investment incorporating issues surrounding sustainability in mind. To build such relationships, it is necessary to think flexibly and develop a deeper understanding of one's own function and role by being interested in other players with whom one may interact, and actively study the work being done by other players. With respect to the main players in the investment chain in particular, a mindset is needed that seriously debates current deficiencies in the building of constructive relationships, how these should be addressed, and what preparations are needed for dialogue. The evolution of the investment chain as a social framework is looked for from the awareness of each player of these interconnections and their efforts to strengthen these.

It can be said that the sustainable growth and healthy development of the economy in the 21st century rest to a large extent on how deeply and unerringly the investment chain as it evolves, absorbs and digests "issues regarding sustainability", as found in the name of this Working Group. Japan's Corporate Governance Code sees publicly listed companies recognising that addressing issues surrounding sustainability is an important part of risk management and properly resolving these, as benefiting "the entire economy and society, which will in turn contribute to producing further benefits to companies, thereby creating a virtuous cycle." The way society and the economy as a whole is seen in the context of mutually beneficial interconnections is the perspective demanded by ESG investment itself.

ESG investment involves intellectual work to connect varied information with corporate value in an integrated fashion from a medium- to long-term point of view, while considering financial information. It is a process to identify the risks to sustainable growth that should be managed and sources of necessary economic profit from information that may at first glance seem unrelated to corporate value. It may be necessary in certain cases to identify areas where it is not possible to succeed through sheer will alone and work with experts when interpreting linkages with highly specialised global issues such as global warming. This can be said to be a process that creates knowledge through connecting with people in a position different from one's own, and ESG investment of its nature gives birth to such a process.

The rapid economic growth after the industrial revolution was to a large part due to the pursuit of efficiency through the division of labour and specialisation, in addition to the aggressive development and use of the earth's resources. During this period financial metrics that were suited to quantification and standardisation became widely used by markets as criteria to help measure corporate value; however, looking rationally at the future going forward in the 21st century, it is extremely important that along with financial information, non-financial information that relates to global issues such as global warming be proactively added to evaluation criteria of investment or corporate activity. For this new endeavour to progress smoothly and effectively in the investment chain, a spirit to steadily and surely, as an organisation or as an individual, rectify and overcome one by one the many issues in front of us – the spirit to initiate action - is vital. This process of building step by step on previous efforts can also be a process whereby investors and companies find value in seeking and creating connections of their own accord and rediscover the importance in economic activity of varied connections. We look for ESG investment, which encourages the enrichment of such "connections" or ties, to function and effect to strengthen from its foundation the ability of the economy to grow sustainably.

End