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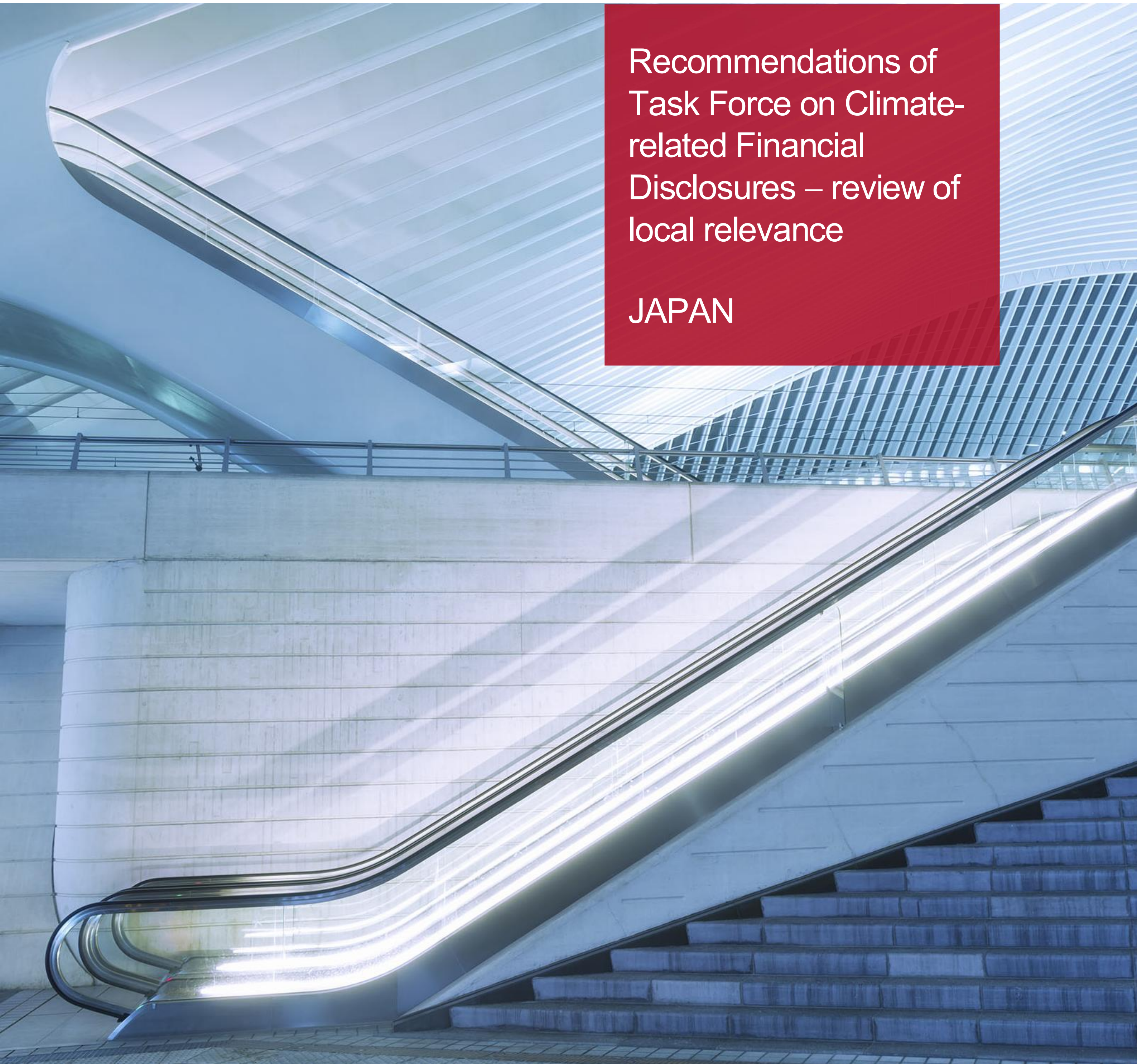
PRI Principles for Responsible Investment



Recommendations of Task Force on Climate-related Financial Disclosures – review of local relevance

JAPAN

1. Background - why this review?

Without better climate disclosure, investors cannot manage risks and opportunities associated with an energy transition. In December 2016, the industry-led FSB Task Force on Climate-related Financial Disclosures (TCFD) released draft recommendations for climate-related financial disclosures. The Principles for Responsible Investment (PRI) and global law firm Baker McKenzie have together produced a series of country reviews examining how these voluntary recommendations integrate into existing regulation and soft law in specific markets, and how investors and companies in those markets can apply them. The country reviews cover Brazil, Canada, the EU, Japan, and the United Kingdom (UK).

This review of Japan's existing regulation describes its existing climate change-related commitments (see Appendix 1), and then considers existing Japanese regulation and policy on climate-related disclosure for companies, and investors/pension funds. Its analysis builds on the findings of the Fiduciary Duty in the 21st Century Japan Roadmap developed by the PRI, UNEP FI and The Generation Foundation to overcome barriers to integrating ESG throughout the investment chain. It also draws on the regulatory analysis from PRI and MSCI's Global Guide to Responsible Investment Regulation, which examined the breadth of responsible investment-related public policy initiatives across 50 economies, including Japan.

The PRI's response to Baker McKenzie's findings

The TCFD's recommendations are voluntary and do not supersede national disclosure requirements or other regulation in Japan. Existing soft law instruments encourage disclosure of environmental performance, material risks and stewardship. The TCFD's recommendations will assist companies and investors in implementing existing guidance. Implementation of the TCFD will also support Japan's national climate change commitments under The Paris Agreement (see Appendix 1).

Three practical actions for better climate disclosure in Japan

1. Government: The Government of Japan should endorse the TCFD's final recommendations, as should the Ministry of the Environment of Japan (MOE) and the Financial Service Agency of Japan (FSA).
2. The Tokyo Stock Exchange: could reference the TCFD's recommendations in its existing corporate governance guidance.
3. Companies and investors: should adopt the TCFD recommendations as a practical framework for climate disclosure. Companies and investors should share good practice to help overcome initial implementation challenges, with reporting convergence needed in the longer term.

Action the PRI will take

The PRI has over 1, 700 signatories in 50 countries, representing over US$72 trillion in assets under management. In 2017-18, the PRI will support:

- Active ownership: we will convene collaborative global investor engagement with companies to adopt the TCFD's final recommendations.
- Investor disclosure: we will evolve the PRI's Reporting Framework with the TCFD's guidance for asset owners and asset managers.
- Investment practices: we will advance investment practices in assessment and management of climate-related risks and opportunities.
- Collaboration with policymakers: we have experience of investment practices and policy in several capital markets; we will draw on this expertise to encourage G20 policymakers to implement the TCFD.
- Addressing barriers around responsibility investment: The PRI has set out its priorities for the next 10 years in its Responsible Investment Blueprint, published in May 2017.

Building on these findings, this review concludes that there is scope for Japan to work towards a stronger disclosure regime, such as that identified by the TCFD under its recommendations. This would assist materially in ensuring climate risk mitigation in Japan, facilitating better investment decisions and assisting with the maintenance of financial stability, as Japan and its global trading partners seek to transition to a lower carbon economy.

2. Private sector regulation

2.1 Disclosure requirements for companies

In the early part of 2016, the PRI mapped out all existing responsible investment policy - almost 300 individual policy tools or market-led initiatives, covering the relationship between finance and ESG issues. These measures can be broadly grouped into three main categories which relate to different parts of the investment chain: pension fund regulations, stewardship codes and corporate disclosure requirements.[1]

There is no mandatory legal requirement for climate risk-related disclosure, or broader environmental, social and governance (ESG) disclosure, by companies in Japan. Corporate reporting of environmental impact and greenhouse gas (GHG) emissions is required, to some extent.

The Environmental Consideration Law of Japan (Law Concerning the Promotion of Business Activities with Environmental Consideration by Specified Corporations, etc., by Facilitating Access to Environmental Information, and Other Measures) requires large enterprises to make efforts to publish an environmental report regarding their business-related environmental considerations. This requirement does not apply to small and medium-sized enterprises.

> To view Japan's complete responsible investment framework, visit the PRI's Regulation Map.
>
> For each measure, it indicates the nature of the rule, the year of implementation, the authority responsible, whether the measure is voluntary or mandatory, and if it addresses ESG issues in isolation or in combination. It also provides commentary on the key clauses relating to ESG factors and investment.
>
> To view the map and download the full methodology, visit the PRI website.
>
> For further information, email policy@unpri.org

The Act on Promotion of Global Warming Countermeasures of Japan (on 2006) requires companies:

- using 1,500KL or more of crude oil equivalent energy per year; or
- emitting a certain volume of GHG emissions per year,

to disclose their total volume of GHG emissions to the government. The government makes the disclosed information publicly available. Japan's stock exchange listing regulations also do not include any rules relevant to ESG disclosure.

In the absence of climate risk-related analysis and disclosure requirements on companies in Japan, Japanese companies may lack strong incentives to conduct the fulsome, forward-facing climate risk analysis recommended by the TCFD. Without market signalling from government of the importance of taking into account climate-related risks, Japanese companies may find it more difficult to achieve the better risk management outcomes which the PRI has found result from comprehensive risk disclosure regimes in other jurisdictions.[2] Such companies may experience issues in navigating the global transition to a lower carbon economy, and may not be in an ideal position to identify opportunities that this transition may present in Japan, such as investment in low emission energy sources and more energy-efficient products and services.

[1] PRI and MSCI. The Global Guide to Responsible Investment Regulation, pages 9-10.

[2] PRI and MSCI. The Global Guide to Responsible Investment Regulation, page 17.

Consideration of the key aspects of the TCFD's recommendations may assist Japanese companies and investors in working towards a more comprehensive understanding of the benefits of corporate climate risk analysis and disclosure, perhaps in stages towards the full scale of the TCFD's framework. This may support Japanese companies in their task of implementing new systems necessary to assess and analyse climate-related, and other ESG risks they face.

A snapshot of soft law instruments that are relevant to ESG and climate risk-related disclosures by companies are set out in PRI's regulatory mapping tool, which forms part of its Global guide to responsible investment regulation. More detail on these instruments is set out below.

Stewardship Code: The Stewardship Code was issued by the Financial Service Agency of Japan (FSA) in 2014. It sets out Principles for Responsible Institutional Investors and, among other things, encourages institutional investors to establish policy regarding their fulfilment of good stewardship responsibilities, and make this policy publicly available. If investors do not comply with some or all of the principles, they must provide reasons.

The Council of Experts Concerning the Japanese Version of the Stewardship Code encourages institutional investors adopting the Code to publicly disclose this on their own websites. The FSA also has published information about institutional investors which have made disclosures on its own website, and established a council which monitors the implementation of the Code by investors.

The Code is expected to be revised in the near future, and the new version will include ESG factors as one of the non-financial, social and environmental factors investors should monitor.

Consideration of the TCFD's recommendations by Japanese companies now may therefore be prudent, in preparation for the revised version of the Code coming into force, and for the (most likely inevitable) further development and broadening of corporate climate risk disclosure regulation in Japan. While the Code is not mandatory, the PRI's findings indicate disclosure can lead to better corporate risk management, as well as reputational benefits which may distinguish participants in voluntary schemes from their corporate competitors.

It is noted however that, in order to achieve the better risk management outcomes that good corporate ESG analysis and reporting can promote (as found by the TCFD), climate-related risk analysis and its integration into "normal" corporate reporting necessitates a consideration the *financial* implications of climate and other ESG risks. It is clear that these risks have a significant financial element for some companies, and this has been recognised in other major jurisdictions. As Japanese regulation of climate risk disclosure evolves, it is highly likely that Japanese investors and global investors in Japanese companies, will begin to expect corporate climate analysis to include considerations of financial risks to companies and their assets.

Japan's Corporate Governance Code: Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid-to Long-Term: The Corporate Governance Code ensures investors have access to the information needed to be an active owner, and companies have a common framework to enhance their governance practices. It proposes five general principles including equal treatment of shareholders, cooperation with stakeholders beyond shareholders, appropriate disclosure of information, proper board supervision and dialogue with shareholders.

In relation to appropriate disclosure of information, it provides that companies should make appropriate information disclosures in compliance with the relevant laws and regulations, but should also strive to actively provide information beyond that required by law.

Such information includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and risks, and governance. It provides, particularly, that non-financial information should be accurate, clear and useful in order to serve as the basis for constructive dialogue with shareholders. It stipulates that the listed company should appropriately engage in the problems related to the sustainability such as social and environmental problems. The Tokyo Stock Exchange's (TSE) amended Listing Rules require all companies listed on the TSE 1st and 2nd sections to "comply or explain" in respect of the JPX Corporate Governance Code.

Principles of Corporate Governance for Listed Companies (Tokyo Stock Exchange): Although these principles are included in UN PRI's Global Guide for Responsible Investment Regulation, TSE's amended Listing Rule stipulates that these principles have been unified and integrated with Japan's Corporate Governance Code.

Environmental Reporting Guidance: A voluntary guideline issued by the Ministry of the Environment of Japan (MOE) for corporate environmental reporting and communication is a tool by which an enterprise may make itself accountable by providing information useful for the decision-making needs of stakeholders/investors. The first version was developed in 2000, and has since been updated regularly, with 2012 version being the most recent.

As part of preparing the 2012 revision, the following were taken into account:

- the impact of the environment on business and the linkages between them, which are seen as deepening over time, along with strategic value of management of environmental issues and risks. Consequently, the demand from investors and financial institutions for systematic disclosure that links the economy, the environment, and society is growing;
- investors are now more interested in analysing the environment's impact on management, including the relationship between the environment and firms' opportunities, risks, material issues, and business strategies, an evaluation of the current situation and future direction, the important financial implications, and enterprises' ability to address these impacts, based on the material information available; and
- a report of the Expert Committee on Environment and Finance, which points out the need to review and encourage the dissemination of the template of the List of Key Performance Indicators (**KPIs**).

Principles for Financial Action towards a Sustainable Society (Principles for Financial Action for the 21st Century): This set of Principles was issued by the MOE, drawn up as guidelines for action by financial institutions seeking to fulfil their roles and responsibilities in shaping a sustainable society. It includes taking a precautionary approach, developing sustainable products, coordinating with multiple stakeholder groups, disclose relevant information and ensuring the institution's board is properly educated. Recommended actions in the Guideline for Asset Management, Securities and Investment Banks include disseminating information to society, and engaging with various investors, by externally disclosure of ESG considerations in proxy voting activities (such as its position, structure and voting results), by appropriately displaying and/or disclosing the purpose and effect of environmental and sustainability related products, etc.

ESG Guidebook (Introduction to ESG Investment): The ESG Guidebook was issued by the MOE, and aims to provide a basic understanding of ESG investment and trends. The Guidebook emphasizes that asset owners and investment managers, as long term investors, are in a position to understand how critical non-financial risk analysis is for the medium to long term growth of corporate value. For example, it discusses risk management and R&D for environmental issues related to business risk (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) and categorises these factors as non-financial information. The Guidebook is comprised of four sections. Part 1 provides an overview of the investment chain, and the relationship between ESG information and investment horizons. Part 2 covers developments in ESG investment in Japan and abroad. Part 3 highlights issues regarding ESG investment, looking at each level of the investment chain. Part 4 examines the role of intermediaries in ESG integration.

Green Bond Guideline: The Green Bond Guideline is a voluntary guideline issued by the MOE in order to encourage the investment for the Green Projects based on the Green Bond Principle (GBP) updated in 2016 and the Paris Green Bonds Statement in 2015. The Green Bond Guideline includes the process of the issuance of the Green Bond or model cases of Green Bond for Green Bond issuers' and Investors' reference and provides the interpretation of the four core components (Use of Proceeds, Process for Project Evaluation and Selection, Management of Proceeds and Reporting) that the GBP refers to.

Accordingly, there is a considerable amount of guidance and voluntary frameworks for integrating ESG risk management into Japanese corporate risk assessment. In order to ensure better corporate risk management and true and comparable assessment of the financial and non-financial risks associated with climate change, it would be ideal to see the development of a uniform disclosure regime, that is applicable to the large majority of companies, and integrated into the financial markets.

For a complete analysis of the evolving landscape of fiduciary duty in the Japanese market, download the Fiduciary Duty in the 21st Century Japan Roadmap developed by the PRI, UNEP FI and The Generation Foundation.

The roadmap builds on conversations with over thirty key market stakeholders and makes recommendations to implement clear and accountable policy and practice that embraces the modern interpretation of fiduciary duty.

The project team is engaging market stakeholders to implement these recommendations.

The Japan roadmap is part of a larger work programme on fiduciary duty, for more information, visit www.fiduciaryduty21.org.

2.2 Climate change-related aspects of pension fund/investor regulation

Some of the above mentioned law and soft law for pension funds and institutional investors that have climate change-related aspects are as follows:

Stewardship Code: Although the Stewardship Code does not directly refer to climate change-related aspects, it requires the institutional investors to understand how to measure risks, including environmental problems experienced by the investee companies. In the draft revised Code, "environmental problems" will be referred to more broadly as ESG issues (but will not specifically mention climate change).

Principles for Financial Action towards a Sustainable Society (Principles for Financial Action for the 21st Century): These Principles consider the risk of financial losses caused by climate change, and promote engagement by investors on such risks. One of the guidelines provided under the Principles, which is a Guideline for Asset Management, Securities and Investment Banks, provides that those institutional investors are socially responsible for the healthy development of capital markets and their appropriate consideration of ESG issues that may affect corporate values would contribute to the formation of sustainable society which offers global environmental protection and the growth and development of healthy capital markets. As an example of the aspects related to climate change, one of the guidelines introduces the plan and practice of the reduction of GHG emissions from the offices, the company cars, the movement of people or the logistics.

ESG Guidebook: The Guidebook mentions that investors who wish to understand medium or long term perspectives on potential investments should invest or make business decisions, taking into account the importance of medium or long term considerations. If they find the risk posed by climate change exceeds the permissible range of the business's activities, such risk may affect the sustainable growth of the investee companies. It notes the investors may invest to improve and avoid such risk situations if they wish to promote sustainable company growth.

Green Bond Guideline: As mentioned above, the Green Bond Guideline includes the process of the issuance of green bonds or model cases of green bond for the bond issuers and investors' reference, and provides the interpretation of the four core components (Use of Proceeds, Process for Project Evaluation and Selection, Management of Proceeds and Reporting) to which the GBP refers. It mentions that the procured funds should be devoted to the investment for the green projects which result in clear environmental benefits or improvements, such as renewable energy, energy conservation, prevention and management of pollution, sustainable management of nature resources, biodiversity conservation, sustainable management of water sources, adoption to the climate change and environment-friendly products. It also mentions that the issuer of the green bond should disclose the negative impacts that the project may cause, such as adverse effects to the ecosystem or noise and illustrate the evaluation of such negative impacts.

The Fiduciary Duty in the 21st Century Japan roadmap recommends a continual focus on a broader understanding of ESG issues and their implications for Japanese investment practice, noting the FSA's overriding mandate which expressly seeks to promote "the sustainable growth of business activities and the wider economy" in Japan and to cope with "uncertainties in the global economy". It also suggests a greater understanding of the financial materiality of ESG issues in Japan should be prioritised, as investor awareness of these issues, and appetite for information on them, increases. There may be a role for trust banks, which can provide policy insight to pension schemes which the schemes will then consider as part of their investment decisions.

3. Conclusion

While Japan has a number of different policies regarding ESG disclosure, Japanese companies may be better positioned for the transition of the Japanese economy (as part of the wider global transition to a lower carbon economy) if:

- Japanese companies and investors begin to consider the risk management benefits of implementing comprehensive climate change risk-related analysis and disclosure, taking information from the TCFD recommendations;
- the financial risks of ESG factors become more comprehensively integrated into business strategy and investment practice.

Working towards adoption by Japanese companies of more climate risk analysis and reporting, which is detailed and forward-facing as envisaged by the TCFD, would ease this transition, for both Japanese companies which will need to grapple with the additional information and processes necessary to undertake this analysis, and Japanese and international investors seeking to understand the real risks posed to their potential and existing investments in Japan.

Appendix 1

Over 146 parties have ratified the Paris Agreement. Its central aim is to strengthen the global response to climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. The goal is feasible, but only if emissions peak by 2020 at the latest. The Paris Agreement requires all parties to put forward “nationally determined contributions” (NDCs), including a requirement to report regularly on their emissions, and on their implementation efforts. In 2018, parties will take stock of the collective efforts to progress towards the goal set in the Paris Agreement. Climate disclosure supports the Paris Agreement goals and NDCs, by enabling company and investor management of material climate-related risks and opportunities.

Japan's 1st NDC includes a commitment to reduce its GHG emissions by 26% below 2013 levels by 2030 (roughly equivalent to a 25.4% reduction compared to 2005 levels). Japan has also set a long-term target of an 80% or more reduction of GHG emissions by 2050, but has not specified a reference year for that reduction.

Under the NDC submission, Japan has also outlined more specific targets distinguishing between emissions types, as set out in the table below.

Type of emission	Reduction target set against 2013 level	Equivalent reduction compared to 2005 level	Actions in key sectors
Emissions of energy-originated CO2	25%	24%	Enhanced energy efficiency systems and introduction of energy conservation technologies in iron and steel, chemicals, ceramics, stone and clay products and pulp products manufacture industries, commercial and residential sectors, transport sector, energy conversion sector and across sectors as well.
Non-energy originated CO2	6.7%	17%	Expansion of blended cement use and reduction of municipal solid waste incineration.
Methane	12.3%	18.8%	Measures targeting agricultural soils and municipal solid waste.
Nitrous Oxide	6.1%	17.4%	Measures targeting agricultural soils and promoting innovative technologies in sewage facilities.
Fluorinated gases (HFCs, PFCs, SF6 and NF3)	25.1%	4.5% increase	Legislated actions on rational use and proper management of fluorocarbons

Japan has also set specific targets for emissions removals in the Land Use, Land-Use Change and Forestry (LULUCF) sector at approximately 37 million t-CO_2e (corresponding to a 2.6% reduction of total emissions in FY 2013), and approximately 9.1 million t-CO_2e by cropland management, grazing land management and revegetation (corresponding to 0.6% reduction of total emissions in 2013 (corresponding to 0.7% reduction of total emissions in 2005)). The country intends to achieve this target by instituting measures for forest management/forestry industry and soil management (leading to the increase of carbon stock in cropland) and revegetation.

Japan has established a new carbon crediting system under the Joint Crediting Mechanism (JCM), as a basis for the bottom-up calculation of its emission reduction target, but also as a mechanism to measure the amount of emission reductions and removals acquired by Japan under JCM as part of its reduction. It estimates that accumulated emission reductions or removals by 2030 through governmental JCM programs range from 50 to 100 million t-CO_2.[3]

[3] Ministry of Economy, Trade and Industry, Japan,' Submission of Japan's Intended Nationally Determined Contribution (INDC)' November 2016 http://www4.unfccc.int/ndcregistry/PublishedDocuments/Japan%20First/20150717_Japan%27s%20INDC.pdf.

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PRI Principles for Responsible Investment

About the Principles for Responsible Investment

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. The principles have over 1,700 signatories globally, representing over US$72 trillion in assets under management.

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