Principles for Responsible Investment

POLICY BRIEFING

PRI SUSTAINABLE FINANCE POLICY CONFERENCE, TOKYO, 3 OCTOBER 2023

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INTRODUCTION

On 3 October 2023, the PRI hosted its annual sustainable finance policy conference in Tokyo, before PRI in Person 2023 (PiP 2023). Each year, the conference explores the latest developments in sustainable finance policy reform and new areas of focus for responsible investors in a changing world. The conference is held under Chatham House rules, featuring panel discussions with policymakers and experts at the forefront of sustainable finance policy. This year, the conference also held breakout table discussions, which saw regulators and investors from around the world participating in active discussions on pressing issues and potential solutions, building on the PiP 2023 theme of “moving from commitments to action”.

This briefing summarises key topics discussed during the event.

SETTING THE SCENE

The main theme of the sustainable finance policy conference at this time was the economic transition.

Economic progress – and the financial returns it generates – relies on the stability and resilience of natural and social systems. If these are threatened, so is present and future economic growth. For decades, policymakers and market practitioners have been increasingly trying to protect the environment and address extreme economic inequality through various approaches and strategies. Despite these efforts, macro-level indicators of environmental and social sustainability continue to move in the wrong direction.

The transition to a sustainable and equitable economy that benefits natural and social systems has become an increasingly urgent policy objective in many countries and within international forums. This transition aims to shift economic activity from practices that exploit and irreversibly degrade the environment to those that the Earth’s natural systems can support sustainably. It also aims to ensure social cohesion by reducing extreme inequality, upholding human rights and protecting vulnerable people and communities from the impacts of transition.

To drive the economic transition, governments are introducing policies and regulations to address climate change, biodiversity loss, macroeconomic instability, effects on the cost of living, etc. However, these reforms are often pursued in isolation and with insufficient influence over business-as-usual public policy and business strategy.

On the same day as the policy conference, PRI launched the research paper *Investing for the economic transition: The case for whole of government policy reform*.

This paper argues that an effective policy approach to redress decades of market and government failures on environmental and social issues must be the responsibility of governments as a whole and needs to be executed as such. It defines what is meant by a sustainable, just economic transition and presents a high-level framework to support governments in pursuing such a transition. It also examines how key jurisdictions are approaching the economic transition – particularly with regard to climate change – and finally explains how investors might best support governments in their efforts.

The report builds on discussions with investors, regulators, policymakers, and intergovernmental and civil society organisations. It represents a first step in the PRI’s engagement on the topic of the economic transition and its findings are intended to start a conversation. This report will be followed by further research, including country-focused analysis, and engagement over the coming year to further drive policy change in support of a just, ambitious and sustainable economic transition.

This year’s conference explored this pressing issue through three panel sessions. Each session explored various policy-level issues that must be addressed to facilitate an effective whole-of-government approach, including inter-regional fragmentation, insufficient ambition levels and policy effectiveness. Furthermore, to ensure that such discussions lead to productive discussions among the global investors present, we hosted table discussions to workshop potential and actionable solutions.

OPENING DIALOGUE: THE GLOBAL GOVERNANCE OF SUSTAINABLE FINANCE – TACKLING REGULATORY FRAGMENTATION

In the first session, panellists with experience in multilateral organisations discussed how multilateral organisations could encourage global policy alignment, mitigate the regulatory fragmentation increasingly occurring with parallel sustainable finance policy reforms, and support economic transition.

Multilateral processes are at the heart of solving the many crises facing our societies. If climate change, biodiversity loss, rising inequalities and pandemics have one common denominator, it is their international character, so it is only natural that multilateral agreements should be central to any response. Over the years, we have seen governments across the globe coming together to agree on ambitious commitments to address critical international issues. Historical agreements have been achieved in these discussions, including the UN Framework Convention on Climate Change in 1992 (followed by the Kyoto Protocol and the Paris Agreement), the UN Guiding Principles on Business and Human Rights in 2011 – and the connected OECD Guiding Principles for Multinational Enterprises – and, most recently, the Kunming-Montreal Global Biodiversity Framework, agreed upon in December 2022. However, reaching these agreements and, even more challenging, implementing them in a coordinated manner that enables states and non-state actors, including financial institutions, to act at a time when international tensions have a real impact on citizens, is a challenging proposition.

A panellist pointed out the gap between the science-based ideal and the reality, warning that the real world is not on pace with the reduction level and speed required by the latest IPCC report. According to the report, GHG emissions should peak before 2025 and decline by 48% (compared to 2019) by 2030 in global modelled pathways that limit warming to 1.5°C. Multilateral frameworks are critical to addressing this gap. The Kunming-Montreal Global Biodiversity Framework was mentioned as a positive example of multilateral agreement as it strictly requires countries to report on progress, which enhances credibility and transparency.

Another panellist explained how the implementation of multilateral agreements can be facilitated by the development of common guidelines. The OECD has been at the forefront of translating the UN Guiding Principles on Business and Human Rights into a “soft law” instrument such as the Guidelines on Responsible Business Conduct Matters, which investors, including our Advance initiative members, use to conduct due diligence on investments. Such developments also inspired policymakers and regulators worldwide to include and embed these Guiding Principles into guidance and regulations. A participant mentioned that the OECD Guidelines are not legally binding in most cases but are still meaningful as they are flexible enough to accommodate countries in different circumstances.

This session also touched on the issue that multilateral agreements, frameworks and guidelines, once agreed upon, tend to rely on national governments to establish and enforce policies and regulations to deliver on their commitments. In addition, it highlighted the risk that a lack of coherence or interoperability between the policies and regulations put in place to implement these agreements in different jurisdictions can create unintended obstacles that limit the capacity of private finance to progress towards the necessary solutions. To address these issues, a participant introduced the OECD peer review system, in which countries mutually oversee the policy development in each country to ensure alignment with the guidelines and manage progress. We also heard a panellist explain the Carbon Border Adjustment Mechanism recently adopted by the EU as an important measure to meet the EU’s climate commitments under the Paris Agreement, which is a positive example of regional alignment. The panellist stressed that the mechanism is designed to be compatible with WTO rules to mitigate confusion among different rules. They added that evidence-based discussions are key to reaching an agreement among such diverse countries.

POLICYMAKER ROUNDTABLE: RAISING THE BAR FOR GOVERNMENT AMBITION TO DRIVE THE TRANSITION

The second session started with an introduction of the PRI's recent research paper *Investing for the economic transition: The case for whole-of-government policy reform*, in which PRI has developed a high-level conceptual framework to support government efforts in the establishment of whole-of-government approaches to the economic transition.

This framework stresses the importance of the economic transition becoming a central goal of public policy, both as a necessary prerequisite for ensuring effective coordination across government and to ensure the consistency of policy goals, implementation measures and collaboration. The research paper is aimed at investors and economic and financial policymakers. It builds on discussions at the PRI's 2nd Sustainable Finance Policy Conference, held in Barcelona in November 2022; interviews with investors, regulators, policymakers, intergovernmental and civil society organisations from January to March 2023; a review of how different governments are approaching the economic transition; and a targeted literature review. It represents a first step in the PRI's engagement on the topic of the economic transition.

Government representatives from France, Japan and Australia spoke at this session, and all agreed that the economic transition sets a new direction not only for capital markets but also for whole economies. They also agreed that the socioeconomic aspects of the transition, such as cost of living and job security, are fundamental to a successful transition strategy and must be embedded into whole-of-government approaches.

In Australia, a participant pointed out, a government structure enabling a whole-of-government approach is crucial to securing a coherent policy approach. For example, it is even difficult to secure policy coherence within one department – a participant mentioned that the Australian treasurer is not always sufficiently considering workforce strategy. The Australian government recently took positive steps towards the development of a taxonomy to increase its climate and clean energy ambitions. Learning from other countries that have been on the journey for a longer period helps to ensure that the policy is aligned with practices in other regions.

Another panellist introduced Japan's GX basic strategy, which aims to create new demand and markets for stable energy supplies and decarbonisation and strengthen the industrial competitiveness and economic growth of the Japanese economy over the next 10 years. This strategy includes various Green Transformation (GX) initiatives, including the expansion of offshore wind power, R&D in storage batteries, and a 20-trillion-yen government investment through the "GX economic transition bond" to encourage further private investment. The Japanese government estimates that these sovereign bonds will help raise the 150 trillion yen of private and public investment required over the next 10 years for the transition. The panellist also introduced sector roadmaps for high-emitting sectors as a cross-department effort and emphasised that these transition policies are critical for both greenhouse gas reduction and Japan's economic growth.

France has clearly set its ambition, taking the lead in international discussions. A panellist argued that the difficulties of tackling climate and social issues should not be an excuse for inaction. In France, the integration of transition planning is performed at the highest political level but not necessarily communicated to the general public, which potentially raises questions about social acceptability. Governmental planification and dedicated budgetary measures are critical.

All panellists agreed that collaboration between policymakers and investors is needed. For example, in Japan, the sovereign transition bonds were designed based on feedback from investors. The Australian government also has ongoing dialogues with investors to enhance the effectiveness of their policies.

WORKSHOP: EMPOWERING INVESTORS AND BUSINESSES TO ENGAGE FOR AN EFFECTIVE, AMBITIOUS ECONOMIC TRANSITION

The third session was a workshop designed to respond to the policymaker roundtable and delve more deeply into specific policy areas. The session was set up with breakout groups, each discussing key topics such as economic externalities, market incentives and enabling finance for the transition. The breakout groups considered policy tools including stewardship, collaborative engagement, sustainability outcomes and transition policy. The breakout group discussions allowed for dialogue between regulators and investor regulatory affairs professionals and collected feedback on different policy reforms. Discussion prompts prepared by table moderators and insights provided by participants in the discussions are as follows:

Taxonomy

- *Do you support the development of transition taxonomies? If so, how should they be designed?*
  - Participants generally considered the extension of taxonomies from sustainable to transitional economic activities to be beneficial and helpful. A framework is needed to enable investors to understand and transparently communicate their support for the transition beyond just investing in sustainable economic activities.
  - Some questions were raised about whether the transition can be accomplished within existing sustainable taxonomies or whether they need new labels (e.g. amber and red), how transition taxonomies should be tailored to specific domestic contexts, and how just transition considerations can be built into taxonomies from the start.
- *Do you believe that DNSH (do no significant harm) reporting should be streamlined? If so, how can this be achieved without jeopardising the integrity of taxonomies?*
  - Participants generally agreed that the principle of DNSH should be retained as a clear standard: the focus must be on improving the concept rather than questioning its core function.
  - Challenges were raised in the application of DNSH, most notably the lack of data. It is crucial to avoid the perception that companies that do not report data are not doing harm.
  - Disclosure and monitoring are important as many taxonomies do not define who will monitor or measure. We need more clear responsibilities and task assignments.

Stewardship

- *What are the potential challenges you face in practising stewardship to pursue sustainability outcomes? Can such challenges be addressed by policy intervention?*
  - The meaning of sustainability outcomes should be clearly defined so that companies and investors are on the same page during discussions.
  - Measuring sustainability outcomes is tricky in the social sphere; this could be addressed through policy.
  - Institutional investors tend to have a limited voice in State-owned enterprises, particularly in APAC regions.
  - Limited clarity on “acting in concert” issues may discourage collaborative engagement.
  - The lack of real economic policy intervention makes it challenging for investors to accelerate the progress of transition.
  - Investment professionals tend to focus on idiosyncratic risks and be reluctant to take on a systemic approach to stewardship, which indicates a need for clear guidance.
  - There are insufficient resources for asset managers to carry out stewardship.
  - More guidance and capacity building for investor stewardship is needed. A minimum standard of what good stewardship looks like is needed. For example, investment managers do not fully understand when and how to escalate and what minimum resources are required.
  - There are challenges in measuring and reporting impacts and outcomes.

- Under the existing regulatory framework, it is acceptable to invest for financial returns but not purely for outcomes.
- *Policy intervention to tackle a potential scenario of greenwashing in stewardship:*
  - While recognising the potential for greenwashing, investors and companies need adequate room and flexibility to make mistakes and learn from them.
  - Policymakers must clarify their expectations on stewardship reporting.
  - Measurement of impacts and outcomes must be standardised, particularly for social issues. Clear definitions, plus taxonomy, might be helpful.
  - The minimum standards for stewardship and enhancing transparency must be clarified.
  - Collaboration across stakeholders must be supported.

Investor Duties

- *How would you define systemic risks? What sustainability risks should be considered systemic risks?*
  - Examples of sustainability risks that could be considered systemic risks include climate change, social unrest, cybersecurity threats, pandemic and biodiversity loss.
- *Has this been clarified in your country or region by a macro-prudential regulator? If not, do you think it is necessary? How would this impact investor duties in your jurisdiction?*
  - There are significant differences in whether this has been clarified by relevant regulators. In some regions, there is some clarity on certain systemic issues, particularly climate change. In some regions, the consideration of real-world impact and systemic issues is actually discouraged (e.g. in the US at the state level)
  - The impact on investor duties and responsibilities varies by jurisdiction, but some shared trends could be identified. In some regions, there is a push for greater transparency and disclosure of ESG-related risks and opportunities by companies, and investors are increasingly expected to consider these factors when making investment decisions. However, whether investors should be obliged to invest for sustainable outcomes to address systemic risks is a matter of ongoing debate and can depend on regional or national regulations and investor duties. Some argue that such obligations could align with fiduciary duties if they contribute to long-term value preservation. Others may see it as a departure from traditional investment objectives.
  - Participants agreed that reforms are still necessary to clarify and formalise the obligations of investors in addressing systemic sustainability risks.

Investor Disclosure

- *Investor disclosure is evolving into a categorised system (SFDR, UK SDR, US SEC); however, shouldn't all ESG disclosure revert towards disclosing outcomes alignment and goals?*
  - Participants generally agreed on wide-ranging disclosure, but think the obligation to disclose detailed information should only apply to products that label themselves as sustainable. They expressed concern about the growing level of detail required by frameworks such as SFDR and national rules, as is the case in France. This poses a particular challenge for smaller firms, as it places a significant amount of pressure on them. Participants agree that we can ask for disclosure across the market but must simplify disclosures and ensure harmonisation across markets.
  - Some participants highlighted that data collection is a problem for emerging markets, where companies are hesitant to provide the information needed for investors to disclose. They believe that additional pressure and regulation are required in these markets before investors can disclose their holdings.
  - Investors agreed on the necessity for regulations on disclosing negative impacts and they supported PAI (Principal Adverse Impact) in this context as no one does this voluntarily. With Article 8 funds, participants believe there is a greater risk of greenwashing, as investors are not willing to be specific about what their product does, which results in vague descriptions and statements.

- *Is a taxonomy necessary in every market to categorise investments? Or are there other solutions in markets where taxonomies are not politically viable? Can market-based solutions overcome political barriers?*
  - Some investors mentioned that taxonomy is very useful to ensure companies meet the same standards and speak the same language, but it requires more detailed harmonisation and definitions and a common framework.
  - Participants highlighted that sustainable investment definition must be harmonised by policymakers. They think SFDR did not address this sufficiently due to the lack of clarity on terms and definitions. They also argued that standardisation of disclosure on different product types is also needed.

Due Diligence

- *It is recognised under UNGPs that investors have a duty to respect human rights via a due diligence process: how can this be implemented via legislation? Do you think mandatory due diligence legislation for the financial sector is an effective way to catalyse action to support the transition to a sustainable economy? How can this legislation be designed to best enable investors to conduct effective and practicable sustainability due diligence?*
  - Some participants agreed with the concept of mandatory due diligence since it promotes sustainability outcomes. However, others thought that guidance (rather than mandatory regulation) is preferable due to the lack of resources available, especially for small and medium-sized investors.
  - According to some participants, regulation should translate and simplify what is a complex process. Investors need standards at the government level, also because developing countries that are not OECD members (and therefore may not be applying the OECD Multinational Guidelines) may have other priorities.
  - Modern Slavery regulations are seen by some as too narrow in scope. For example, they do not cover the whole spectrum of issues identified by the ILO (International Labour Organisation).
  - Importing companies should ensure that due diligence is undertaken via contractual agreements. Investors should confirm that this is being done.
  - Some participants with global portfolios highlighted that it may be challenging to navigate different standards in different countries, which risks a piecemeal approach. For this reason, regulation standardisation would be useful.
  - Regulation must steer investor engagement with companies and evaluate performance (as a benchmark of practice).
  - It was highlighted that, for many regulations, the focus is more on transparency (as with most modern slavery acts). Action on human rights (as required by due diligence) should instead take precedence.

Economic Transition

- *What conditions must be met to enable governments to adopt a whole-of-government approach for the economic transition?*
  - Participants agreed that a whole-of-government approach should be able to withstand political cycles so that the approach is not affected when a new government comes into power. Some governments have implemented ambitious policies (e.g. Japan, Australia and the US), but how does one ensure these are permanent?
  - Participants agreed that governance will be important and that ministries are coordinated and empowered to integrate the economic transition into their policies. Power dynamics between ministries must also be addressed: for instance, although a “just transition” requires a labour force transformation perspective, the labour ministry is generally given less (financial) support and power across all countries.
  - Some participants also raised the importance of moving the whole-of-government approach beyond the realm of climate change.

- *How can investors best engage with policymakers to support the economic transition?*
  - Participants broadly agreed that investors should participate more actively in the policy development process by, for instance, joining working groups established by the government.
  - Participants indicated that organisations in the private sector must continue to show leadership: they are powerful and can be an example to the government through their own activities.

Climate Policy

- *What do you see as the role of investors regarding policies related to the economic transition and national emissions reduction targets? To what extent is the decarbonisation of portfolios dependent on national and international policy?*
  - Enabling policy environments is critical. In Australia, the finance sector stepped up and now the government is taking the issue seriously and has legislated net-zero targets thanks to vociferous calls from investors. As a result, the economic transition is accelerating.
  - We can't rely solely on investors to solve issues of climate change but they can collaborate with governments: they have the actual assets to invest and can inform governments where the bottlenecks are to mobilise assets and allow governments to set policies accordingly.
  - On the other hand, it is also important to ensure that the regulatory environment is not preventing decisions from being made – i.e. if there is too much reporting. Policy should be supportive and enabling of investors in the economic transition.
- *What public finance instruments – at the international and national levels – should be leveraged to crowd-in private investments to de-risk new technologies and help close the current finance gap for the net-zero transition?*
  - Grants are important, as are other blended finance instruments, such as green municipal bonds. Investing in climate tech requires significant time for commercialisation, so startups receiving grants in the EU or US is a helpful starting point. The Inflation Reduction Act in the US, whether it is the best instrument or not, has thrown down the gauntlet, and teams will move to the most cost-effective option.
  - Asset managers want to help and invest in transition projects, but they have strict rules on yield and duration, which makes it challenging to find projects that are the right size and fall within constraints.
  - In Europe, regulation was not clear, so it made no sense to invest in solar and wind after a certain number of years. Therefore, a buffer must be established with public or international organisation money to help adjust the costs.
  - Conversations were held in 2018 at the UN on closing the finance gap and how to crowd-in private capital, but now the interest rates are higher than they were in 2003. Matching duration is very important – we are asking for tightened regulation but also more concessions from private finance.
  - We need to be aware of mechanisms that will allow transition funds to go into dirty assets to shut them down because divesting doesn't mean an asset will disappear, it will just go from one balance sheet to another – phase-out is paying someone to actually manage that.

Social Issues

- *The economic transition will require huge investments and upfront costs. To be successful, the transition must be seen as fair and not imposing excessive costs on the most vulnerable sector of the population. How do we square the circle at the regulatory level between social needs and necessary action on the economic transition?*
  - According to most participants, social needs should be integrated into government transition plans as a standard element. Emphasis must also be distributed across social factors alongside climate and nature, considering the interconnection between these issues. Moreover, solutions must be developed not just within countries but between countries as well, with externalities priced across developing and developed countries.

- It was highlighted that the investment ecosystem depends on savings. Living wages, adopted as a baseline along with collective bargaining, can bring higher living wages and bolster savings. This could also bring revenues for governments to invest, creating incentives for the public and private sectors.
- There is an increasing shift in and among pension funds that are seeing broader systemic risks. We won't meet climate targets if we don't have community transition – this will lead to larger risks for investors.

Nature Policy

- *What type of policy instruments are most suitable to incentivise investors to pursue positive outcomes for nature? What are the enabling conditions for such policy instruments to effectively mobilise investor action?*
  - The pricing of externalities, like carbon pricing, and valuing nature would facilitate the integration of nature considerations into decision-making. A complicating factor, however, is that nature has highly localised characteristics. Therefore, the question becomes how to integrate local characteristics into pricing and valuation mechanisms.
  - Disclosures are an important first step. With the launch of TNFD, there will be increased scrutiny of nature elements. Increased disclosure requirements and building up data for nature are important.
  - We need capacity-building for investors to better understand the nature element and its implications for finance and investment.
  - Policies to curb deforestation and protect indigenous people are needed, and they must be paired with effective enforcement. These policies must be designed and implemented through coordination between different governmental departments to ensure all stakeholders, including investors, play a role in contributing to this issue.
- *Nature-related financial risks and opportunities act as key drivers for investors to integrate nature-related considerations into the investment process. Between risks and opportunities, nature-related financial opportunities and returns are relatively less understood. How can policy create a market, or at least more certainty, for investment opportunities and returns that contribute to a nature-positive economy? Should such policies be pursued?*
  - The investment community is in need of more scientific education on nature, its systems and its value.
  - The first step is to disclose negative impacts on nature; disclosures on positive impacts are next. Existing standards on nature-related credits and offsets attempt to capture the positive impacts of projects, but the credibility of some of these standards is questionable. It would be beneficial to learn from peers within the investment community how investee companies are handled and managed, particularly regarding claims of positive nature contributions.
  - Many "nature positive" investable projects are still small in scale. Effectively identifying more and larger scale projects would be beneficial. Plus, we need to inject different sources of finance to scale up these projects beyond the seed stage.
  - Governments can help develop and improve the valuation of nature and create monetary benefits for conservation.
  - A challenge is that existing ESG data providers don't include geospatial data. This limits the ability to monitor the local changes or improvements to an ecosystem.

REGULATORY ROUNDTABLE: DISCUSSING THE SOLUTIONS TO EFFECTIVE POLICY IMPLEMENTATION

In the last session of the day, regulatory representatives from Hong Kong, the UK, Japan and Malaysia gathered to discuss key aspects of ongoing regulatory developments to enable sustainable finance and address questions raised during the investor workshop.

A participant mentioned that Hong Kong's role as a global sustainable finance hub is especially important given its proximity to Chinese capital. In 2018, the Hong Kong Securities and Futures Commission (SFC) published a strategic framework. In 2021, the SFC revised the fund manager code of conduct to align with TCFD recommendations. Large fund managers are expected to do more than others, who are expected to do the minimum. A participant also argued that ESG funds are defined as those that incorporate ESG factors as a key objective. The regulatory objective is to improve the disclosure and transparency of funds, as well as reduce the risk of greenwashing.

In the UK, the Financial Conduct Authority (FCA) coordinates with investors and stakeholders before the consultations are released. Another participant stressed that it is easy for policymakers to introduce rules, but it is difficult to ensure that they are effective and achieve results. The FCA learned from the IOSCO recommendations and the Japan Financial Service Agency (FSA) example to introduce a voluntary "code of conduct" for ESG rating and data providers. This is proportionate and quicker to implement while laying the groundwork for future regulation. The FCA is working with the Global Financial Innovation Network (GFIN) to leverage technology and create a better ecosystem to identify cases of greenwashing.

In Japan, the FSA takes a principles-based approach rather than a regulatory approach. The Green, Social and Transition Bond Guidelines provide principles-based guidance on how to sustainably invest, while also encouraging voluntary innovation and initiative. Another participant also mentioned that Japan is a big proponent of the TCFD in terms of climate disclosure. They mentioned that Japanese statutory requirements are largely voluntary as well – companies can decide what is material on their own, and Japan is taking a voluntary soft-law approach to allow for flexibility and room to grow. A participant added that there is a trade-off between the level of ambition and inclusiveness ("no one left behind"), but when market maturity progresses, the FSA will consider more strict regulation as well.

In Malaysia, one of the key roles of the Sustainability Securities Commission is to protect investors. In terms of sustainable disclosure, a participant explained, it mainly focuses on taking a phased approach. Feedback from investors before implementing policy is critical. It also looks at different market regulations such as in the UK, Hong Kong, and Singapore to maintain alignment.