Recommendation from the High Level Meeting on ESG Finance
– Toward becoming a big power in ESG finance –

July 27, 2018
High Level Meeting on ESG Finance

We understand that a strategic shift toward a decarbonized, sustainable society is exactly the source of Japan's competitiveness and "new growth," as both the Paris Agreement and Sustainable Development Goals (SDGs) pursue such a society. Against this backdrop, we have confirmed that it is essential to develop ESG investments, which are being accelerated ahead in direct finance, into those with a larger social impact, and to realize ESG financing in indirect finance through collaborations between regional financial institutions and local governments, etc. with financial institutions' responses to the global trend in mind. To accomplish this, while each stakeholder fulfills his or her respective role, we recommend the Japanese government also to take necessary actions.

<Outline>

1. Beginning of innovation toward decarbonization

In an effort to shift to a decarbonized society and create a sustainable economic society realizing SDGs, financial sector's leadership is strongly called for in stimulating green finance and shifting toward ESG finance.

In the world, central governments and companies of many countries have been taking bold and strategical actions for a radical shift from a fossil fuel-dependent society/economic structure in conjunction with responses to risks of climate changes as well as realization of SDGs against the backdrop of concerns about the earth's environment and social challenges. It is also pointed out that a shift to a business model toward a decarbonized society in particular is companies' major agenda for survival. Movements of divestments from stranded assets in direct finance markets and proactive engagements with companies are advancing. Making decisions on investments and loans after considering the climate change risks and other factors is becoming common mainly in European financial markets. Meanwhile, potential markets are globally expanding and providing opportunities for new businesses, leading to a possibility of successful corporates entering the leadership bracket. Climate changes are not only an environmental concern anymore.

Japan, as the chair of the next year's G20 Summit, should accelerate its speed to consider designing a long-term strategy to lead the world's energy transformation and decarbonization. We request the government to lay out a consistent national policy for creating a society in the future. The central government's specific and consistent policy for a decarbonized society and its clear signal are indispensable for ESG finance to considerably spread in Japan. The carbon pricing issue was dealt with by the Ministry of the Environment, Japan (MOEJ), for deliberations and saw a report by the "A Panel of Experts to Consider How Carbon Pricing should Work" in March 2018. Information related to climate changes, which is important in business management strategies, can be utilized by financial markets as a price signal useful for making decisions on investments and loans, when the frameworks are developed for carbon pricing as a value scale in the society and for information disclosure discussed below. This will make it easier to identify transition risks associated with financial stability. Consequently, this will accelerate a strategic shift in the allocation of all resources for move/transition to a new, sustainable society/economy as a global trend, bringing in "new growth."

2. Toward a swift establishment of ESG finance that supports sustainability of the country and regions

Rebuilding of a long-term and reasonable framework for investments that support a sustainable society and economy has been progressing.

The world is beginning to share the concept of fiduciary duty (responsibility of institutional investors who are entrusted with asset management by asset owners) in the 21st century, mainly in the Europe and the United States. The "Fiduciary Duty in the 21st Century" report on Principles for Responsible Investment (PRI) states that, failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practices is a failure of fiduciary duty. A wide spread of such an idea in the society will form the backbone of expansion of ESG investments. In Japan, although the law does not specify the fiduciary duty, the following view is becoming common that asset management with medium- and long-term perspectives in light of ESG factors does not contradict the fiduciary duty at least as long as such practices do not deteriorate financial performances during the investment period. For universal owners in particular, it is essential to minimize negative externality (such as environmental and social issues) and have continuous and stable (sustainable) growth of the entire market. In addition, it is reasonable to consider ESG factors.

Direct finance has been thought to lead the expansion of ESG finance. On the other hand, promoting indirect finance, which has an overwhelming significance in Japan, is crucial for the establishment of a sustainable society/economy, including the country's transition to a decarbonized society.

We must increase financial flows for the establishment of sustainable regions toward creation of a Regional Circular and Ecological Sphere that finds simultaneous solutions to local social and economic issues and realizes SDGs in the regions. It will be increasingly important that regional financial institutions and their management reflect their own management philosophy, have a full realization of social impact on the region, and fulfill their role. In the meanwhile, especially for listed regional financial institutions, dialogues conducted by institutional investors who are the shareholders with the financial institutions with a conscious awareness of ESG factors will prompt these financial institutions in realizing SDGs. Therefore, building constructive relations between direct finance and indirect finance through dialogues is extremely important for the promotion of ESG finance.

For establishing a sustainable society and economy, a paradigm shift of capital markets is required so that social impact of investments and loans is taken into account. There is also an idea that we have to expand the concept of investments and loans from two dimensions of risk and return to three dimensions of risk, return, and social impact, to build new rationale of investments and loans.

In the first place, all companies and financial institutions have an aspect of social existence and the responsibility to act for ensuring a sustainable society. To act according to this responsibility, long-term perspectives, human resources with ESG literacy, and the ability of the company's human resources to accurately communicate their ESG issues to stakeholders are the key factors.

The financial industry where people, goods, and money tend to cluster plays an important role in the spread of SDGs and ESG finance, eventually leading to the simultaneous pursuit of sustainability and economic growth. In Japan's direct and indirect finance industries, the top management should share a sense of crisis and the global trend and should show their will to take the initiative on ESG finance using strategies based on long-term perspectives.

Based on the above understanding, this High Level Meeting proposes the following recommendations, reflecting vigorous discussions made from the perspectives of direct finance and indirect finance.

<Specific recommendations>

3. Acceleration of ESG investments in the direct finance market

ESG investments are expanding rapidly. A new growth in a sustainable economy and society will be generated by firmly developing this move in Japan's financial markets and furthermore establishing direct finance that has an impact on the sustainability of the environment and society. Therefore, we believe that market players including institutional investors, such as pension funds, companies, brokers, service providers, and stock exchanges, and the government should work on the following items.

(1) Toward productive dialogues regarding ESG information

(i) Promotion of information disclosure in light of the Task Force on Climate-Related Financial Disclosures (TCFD)

It is impossible to avoid the move toward improving a framework of information disclosure, taking into consideration the recommendations of the TCFD set up by the

Financial Stability Board (FSB-TCFD), because such a move is accelerating as an international trend. The TCFD requires the companies to disclose voluntary information regarding the establishment of a governance system that appropriately responds to climate changes, business strategies formulated under that system, the methods of managing risks and opportunities, and business benchmarks/targets. A stereotypical or formal framework of information disclosure will be inappropriate, and these requirements are applicable to both financial and non-financial sector companies. Based on these recommendations, companies that have global operations in particular should understand that promoting information disclosure through scenario analyses leads to maintenance of their own corporate value. They should take actions without delay. The government has to become proactively engaged in the development of international framework and encourage transmission of the company's information to the world by showing how companies should understand climate-related risks and opportunities from a financial standpoint and disclose information so that information disclosure based on the TCFD is used during dialogues in the investment chain. Additionally, the government should motivate the actions of private sectors based on the framework of the TCFD; for example, by implementing supportive measures for the development of strategies toward the climate scenario of two (2) degrees centigrade or lower.

(ii) Infrastructure improvement to encourage the disclosure of environmental information

In unlocking potential unique to Japanese companies, it is extremely important that investors and companies conduct constructive dialogues on environmental /social challenges that the companies face, and on management strategies to address those challenges. For achieving this, it is important to broaden the base of the company's disclosure of environmental information through integrated reports etc. It is also important to develop a framework for encouraging disclosure of environmental information in light of global trends and to improve infrastructure for information including ESG Dialogue Platform. In view of the current situation where ESG information in an integrated manner is not readily available to investors, infrastructure improvement to boost the convenience is awaited.

Traditionally, the Corporate Governance Code, which is principles of action for listed companies, specifies that companies should appropriately disclose "non-financial information" under laws and regulations, and also voluntarily work on the provision of information other than disclosure required under laws and regulations. However, the recent revision of the Code has clarified that such "non-financial information" includes information on ESG factors. The Board of Directors of listed companies needs to proactively get involved in information disclosure so that disclosed/provided information, including non-financial information, will be valuable to users.

(2) To impact the sustainability of the environment and society

(i) Expansion of financial instruments taking into account ESG factors (particularly "E")

It is often pointed out that ESG investment opportunities are absolutely scarce in Japan against its rising needs. Financial institutions are expected to make efforts to expand moves of considering ESG factors to all asset classes such as financial instruments, including stocks and bonds, and real estate.

Government's support for these efforts of financial institutions is also expected. Green Bonds are attracting expectation for further expansion of its market size in Japan through political supports such as subsidies for additional issuance cost and the Green Bond Issuance Promotion Platform implemented by the MOEJ. In accordance with the market expansion, market players are expected to develop index, funds for Green Bonds, and so forth.

In addition, we hope that the government and players in the direct finance market will consider establishing a structure for selecting and publicizing excellent companies that strategically incorporate environmental factors in the corporate management as environmentally sustainable companies. This structure will politically encourage companies that increase their corporate value by addressing environmental challenges strategically and proactively.

It is desirable for institutional investors to clarify policies on ESG investments; for example, investing in ESG-related issues if conditions such as yield are nearly the same. This is a natural trend with the prevailing concept of fiducial duty in the

21st century.

It is also pointed out that Millennials, who are said to be oriented toward investments with environmental and social issues in mind, should be developed to be individual, long-term investors. It is also expected that individual investors will be given opportunities for investment of high quality financial instruments and education with awareness of ESG/SDGs.

Furthermore, there are also opinions that stress the needs of incentive measures to firmly develop ESG investments. In this regard, we must refer to initiatives in Japan and abroad. For example, Europe has introduced measures of mitigating infrastructure investment risks in "Solvency II," a financial health standard for insurance companies.

(ii) Engagement by institutional investors etc.

The Stewardship Code, which defines the principles of action for institutional investors, illustrates risks and earning opportunities related to social/environmental issues in the governance and businesses of investee companies as a viewpoint in the institutional investors' understanding of the situation of investee companies from a medium- to long-term perspective. When institutional investors conduct engagements (constructive dialogues) or exercise voting rights, they are expected to appropriately consider ESG factors at each institutional investor's discretion.

(iii) Self-assessment and disclosure by parties in capital markets

Parties involved in direct finance, including institutional investors and companies, are expected to make a self-assessment of current effort status for ESG investments from a long-term perspective and voluntarily disclose results of the assessment. Such promotion of transparency leads to an increase in corporate value and plays a powerful role in autonomously encouraging internal discussions in each stakeholder.

Among others, institutional investors are expected to voluntarily disclose their ESG investment policy on which they depend in assessing investee companies, and the practice of ESG investments according to their situation, just as asset managers that have signed PRI are required to report activities and progress of implementing ESG investments. This will contribute to beneficiaries' investment decisions and continuation of ESG investments, allowing investee companies to promote business activities aimed at solving ESG challenges more easily.

4. Toward promotion of ESG loans through indirect finance

Given Japan's financial structure centered on indirect finance, encouraging considerations to ESG in loan will also be a key to expansion of sustainable and inclusive ESG finance.

"ESG loans" means loans made with considerations of environment, society, and governance. For example, loans are provided for businesses that have an environmental/social impact, such as renewable energy business, energy saving business, recycling business (hereinafter referred to as "environmental/social businesses"), based on the evaluation of customers' business potential and the company's perspective of the ESG factors.

Globally, management of the entire supply chain has been strengthened in relation to responses to ESG challenges. As globalization of regional businesses is being advanced, companies and financial institutions that do not take into consideration ESG challenges could face a downside risk. Small- to medium-sized companies may also face risks that come to the surface by being forced to suddenly review transactions because of the enhancement of the supply chain management in relation to climate change issues by large companies. Meanwhile, they could have business chances for developing new customers by turning to ESG challenges and making pre-emptive moves. The efforts of financial institutions on ESG are important in reducing the risks of borrowers and bearing a chance of taking in a new business through efforts for ESG. It could result in maintaining and improving the corporate value of borrowers and an eventual increase in the competitiveness of regional companies through enhanced supply chain supporting a Regional Circular and Ecological Sphere and improvement in the sustainability of regional communities.

Therefore, we believe that financial institutions, institutional investors, companies, and the central and local governments should work on the following matters:

(1) Simultaneous solution for regional social/economic challenges through regional ESG finance

(i) Stance required for regional financial institutions as the core of the region

Regional financial institutions are the core of a region where local people, goods, and money tend to cluster, and their role is to increase the sustainability of regional economy. On the other hand, shortage of manpower and shrinking of the market are continuing in conjunction with a declining population of productive age and aging in regions. Regional financial institutions are facing the need to think of the future direction of businesses together with local companies, in terms of how to increase their productivity while searching for new source of revenue. Under the strict business environment, many regional financial institutions need organizational and continuous initiatives for building a sustainable business model. In such cases, it is not an exaggeration to say that <u>establishment of a sustainable customer-oriented business model is difficult without a perspective of customers' ESG challenges and regional SDGs</u>.

In the first place, <u>ESG can be an imperative concept for indirect finance that requires utilization of various corporate information, including non-financial information for credit decisions and management</u>. ESG finance in regions is the same as rediscovery of this concept and pursuit of true relationship banking. <u>While having such recognition across the entire organization, regional financial institutions should have the structure and human resources in place and genuinely work on lending based on evaluation of customers' business potential and support for main business lines under the top management's leadership</u>.

In addition, regional financial institutions are encouraged to <u>"visualize" their efforts for financial intermediary</u> using benchmarks for financial intermediary functions etc. In the "visualization," <u>it is effective to also disclose efforts focusing on ESG and SDGs as one piece of non-financial information</u>. This will lead to review of the regional financial institution's business model and sustaining/improvement of its corporate value, allowing institutional investors to reach out to the regional financial institutions and formulate an investment strategy more easily. It may help fulfill their accountability to stakeholders surrounding them, including regional financial institutions over which institutional investors do not have any influence.

(ii) Efforts toward realization of ESG regional finance

To further expand the establishment of a sustainable society and economy in regions, regional financial institutions are expected to provide necessary support such as provision of appropriate insights and finance as financial institutions with considerations for ESG factors according to the characteristics of the region (ESG regional finance). There is recognition that ESG regional finance increases sustainability of the region and, at the same time, contributes to securing of the revenue base for regional finance.

Hence, regional financial institutions are required to proactively discover local ESG challenges that have potential of leading to a business, and to be engaged and cooperate in building new businesses and leveraging a wealth of know-how on finance, in collaboration with local governments and others. It is also pointed out that development of a structure for such efforts will enable financial institutions to accumulate insights necessary for lending based on the evaluation of customers' business potential etc. with consideration of ESG factors, thereby decreasing non-financial risks.

(iii) Regional finance focused on "E" toward generation of a Regional Circular and Ecological Sphere

Toward generation of a Regional Circular and Ecological Sphere, in addition to the efforts in (ii), further promotion of regional finance particularly focused on "E," in particular by incorporating environmental factors in evaluation of customers' business potential, will be important.

To achieve this, environment-conscious loans etc. dealt with by regional financial institutions must be appropriately backed up so that such loans do not become a mere facade. In this regard, an interest subsidy program and other measures are effective from the perspectives of promoting both borrower companies' efforts for ESG-driven management and environmental/social businesses and ESG loans made by regional financial institutions.

In addition, regional small- to medium-sized business operators, who must lead regional environmental/social businesses, often suffer from fundraising. As for regional decarbonization businesses, there are also efforts to improve the capital strength of businesses through the government's supply of risk money from "Green Fund" for promoting investments in regional decarbonization businesses etc. to ensure smooth investments and loans of regional financial institutions and other parties. These efforts keep playing an important role in supporting environmental and social businesses in the regions.

(iv) Importance of ESG-driven management of small- to medium-sized companies

Efforts of small- to medium-sized companies in the regions are also important in their role as borrowers. We hope managers of small- to medium-sized companies become more aware of the importance of ESG-driven management. While there are many ESG challenges that small- to medium-sized companies are expected to address, simultaneous solutions for work-style reforms and CO_2 reduction through visualization of environmental effects may be one of those challenges. For example, it is important to develop and establish ESG-driven management through the Eco Action 21, which is a tool for promoting environmental management for small- to medium-sized companies. Furthermore, when managers of small- to medium-sized companies, facing difficulties receiving loans, work to visualize ESG-driven management by making use of local benchmarks and others, this may enable their companies to obtain loans more easily. This will allow both regional companies and financial institutions working on ESG challenges to function like the two wheels on an axle, leading to a potential sustainable business model. The government should further advance such measures to back up efforts of small- to medium-sized companies.

(v) Restructuring of the ecosystem for regional finance

The fund needs of regional environmental/social businesses have diversified, fragmented, or become smaller in size. For these businesses, it is possible that regional financial institutions, local residents, and local governments, etc. fulfill their respective roles in an endeavor to further diversify parties responsible for regional finance, by developing new parties who take on social finance, in addition to fostering the existing ones, and restructure the ecosystem for regional finance (system of routes connecting fund suppliers and fund receivers in regional finance). Social investment funds, community foundations, regional development funds, and so on that have already been promoted at the private sector, and the establishment of multi-layered ecosystem through independent-minded and proactive collaboration with local governments and regional financial institutions, will have an impact on creating new businesses and hence leading to new jobs in the region. Therefore, this is important in the formation of a Regional Circular and Ecological Sphere. Circulating funds within a region up to the end galvanizes the regional economy and regional society, and increases the sustainability of the basis for regional financial institution activities.

(vi) Cooperation with local governments toward solution of regional challenges

Cooperation with local governments is essential to unearth regional challenges and create new initiatives to generate cash flows. New environmental/social businesses leading to the vitality of regions are created through local governments' proactive implementation of measures to realize SDGs and address ESG challenges, as well as financial institutions' fulfillment of relationship banking functions. <u>Local governments should increase the quality of their activities with an awareness of their role required in ESG regional finance while sharing good case studies, etc.. For example,</u> we hope that <u>they develop a municipality version of the Principles for Financial Action for the 21st Century.</u>

(2) Further spread of ESG loans

As one of ESG loans, megabanks conduct project finance in which environmental effects and others are assessed based on the Equator Principles, which have been prevailing internationally, whereas Development Bank of Japan and others use a financing method by which non-financial information is incorporated to evaluate corporate value as Environmentally Rated Loan Program in Japan.

<u>ESG loans support borrower companies to expand their business opportunities by visualizing their non-financial strengths for the eyes of financial institutions.</u> It is necessary to deal with these loans as one of significant managerial strategies. Strong determination of the top management is important to prevent ESG loans from becoming a mere facade. In addition, there was also an opinion that listed indirect financial institutions were expected to voluntarily disclose the current status of their efforts for ESG loans and others in light of their size, characteristics, and others.

(3) Responses in indirect finance toward a decarbonized society with global trends in mind

Globally, there is also a budding movement to consider that it is imperative to give attention to climate change risks for the future generations in the indirect finance field. We hope that financial institutions themselves will promote disclosure of information on the efforts to address climate change issues and increase transparency.

In the future, financial institutions may face review of loan portfolio by evaluating asset value from a long-term perspective. Amid international competition under a big paradigm shift for dealing with the crisis of global environment, we believe it is also effective that financial institutions quantitatively assess loans etc. for businesses contributing to the solution of climate change issues and disclose the information in light of the size, characteristics, and others. There were opinions that such attitude will help achieve accountability to the world and reduce the risk of transition of financial institutions themselves resulting in the maintenance of the corporate value, a target setting common in foreign countries is also expected in fulfilling accountability, and the government should formulate standardized definitions for ESG finance, carbon-related assets, and others as part of necessary measures for the premise of above. If transparency increases in this way, direct finance will be linked with indirect finance and ESG finance in depth will be realized.

5. ESG finance literacy and research etc.

To increase the quality and volume of ESG finance, improvement in abilities and motivations of people in charge on site, and information analysis and research for practice of ESG finance are essential. Therefore, financial institutions, brokers, institutional investors, companies, etc. and the central and local governments should work on the following matters.

(i) Improvement in ESG information literacy

For qualitative improvement of ESG investments, it is important for both companies and investors to improve information literacy with regard to relations between corporate value and ESG information. The government, financial institutions mainly involved in direct finance, relevant organizations, etc. should develop programs, in particular for "E," for the development of analysts and specialists in collaboration with international institutions, NGOs, and so on, because "E" is difficult to understand and interpret in the context of corporate value.

(ii) Development of human resources supporting ESG regional finance

For regional financial institutions to make substantial progress in ESG regional finance, human resources with the following abilities are indispensable: (i) ability to discover environmental/social businesses that can contribute to solution of social/economic issues in regions, (ii) ability to propose environmental/social businesses to companies, and (iii) ability to figure out feasibility in light of characteristics of the environmental/social business. The financial industry and the government should work together to foster these human resources.

(iii) Improvement in ESG finance literacy of the public

Improvement in ESG finance literacy enables each citizen to achieve economic self-reliance and make a better life, thereby contributing to the realization of a sustainable society that achieves SDGs while endeavoring to make the transition to a fair, decarbonized society. Financial institutions, brokers, the government, and so on should improve ESG finance literacy.

(iv) Making honorable recognition of ESG finance that had good social impact

The government should set up a system to appraise and recognize the efforts made by institutional investors, financial institutions, brokers, companies, and so on that positively impacted the environment and society through actively addressing ESG finance or environmental/social businesses.

(v) Research on ESG finance etc.

The government and financial institutions mainly working on direct finance should involve Japan's academic circles to advance research on demonstrative analysis of ESG finance and others such as ESG index, green bonds, relations between ESG factors and credit rating, and the impact of ESG finance on the society. As the foundation of the research, the balance of ESG investments in Japan should be compiled and disclosed accurately. The government should conduct analysis and research of situations surrounding ESG finance in Japan and abroad, such as trends of fiduciary duty and green finance, and strive to provide accurate information.

6. Toward a big power in ESG finance

Because ESG finance requires a long-term perspective, it is important for all stakeholders involved in ESG finance to work on the finance with a conscious awareness. We recommend that each industry leader in the financial and investment fields and the government work together to set up the "ESG Finance High-Level Panel" (tentative name) as the place for discussions and actions to improve the awareness and efforts on ESG finance, and regularly follow-up the progress of these efforts based on this recommendation.

As a system for expanding of and implementing efforts for environmental finance, Japan has the "Principles for Financial Action towards a Sustainable Society (Principles for Financial Action for the 21st Century)," in which more than 250 financial institutions have already participated. Promoting implementation of the principles in an expansive manner will lead Japan to the path for a big power in ESG finance. We expect to ensure a complete alignment of activities of the above panel with its principles.

Amid facing the planetary boundaries now, a paradigm shift is occurring toward a sustainable society that realizes SDGs, while trying to make a transition to a decarbonized society. A strategical shift in resource allocation should accelerate transition to a new society and markets generated from the global trends. Efforts for ESG finance in Japan have just begun. Japan may be unable to keep up with other countries without a swift response to rapidly progressing global movements. The financial industry and the government must advance ceaseless efforts for ESG finance as a new driver of growth.

Japan will chair G20 in 2019. While each country is highly interested in ESG investments and sustainable finance, Japan will be able to take the initiative in international discussions only after credibly explaining the picture of its ESG finance to the world. Japanese companies, including small- to medium-sized ones, have unique strengths obtained by working on the ESG field ahead of peers. Their efforts will lead the world in handling both direct and indirect finance with a view to regional details, targeting realization of sustainable and inclusive ESG finance. Domestic and overseas frameworks for addressing ESG finance, such as the Principles for Financial Action for the 21st Century and PRI, are available for use. Therefore, we recommend the public and private sectors to work together in creating strategies for Japan to become a big power in ESG finance, communicate them in and outside Japan, and implement the same in a steady manner.