The Expert Panel on Sustainable Finance, FSA

The Second Report

- Financial systems that open up a new sustainable society -

July, 2022

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1. Introduction

Constructing a sustainable society is a major challenge of our society today. The adoption of the Sustainable Development Goals (SDGs), the Paris Agreement and other important milestones has shown that it is essential to promote sustainable finance, which encourages the society to transit to new industrial and social structures and realizes a sustainable society.

Based on this recognition, the FSA's Expert Panel on Sustainable Finance (hereinafter, the Expert Panel) compiled and published the report by the Expert Panel on Sustainable Finance - Building A Financial System that Supports a Sustainable Society (hereinafter, the First Report) in June 2021 on various measures to promote sustainable finance.

The First Report positions sustainable finance as "infrastructure supporting sustainable economic and social systems" and summarizes measures to promote sustainable finance based on three pillars: enhancing corporate disclosure, capital market functions, and the roles of financial institutions (FIs). It also encompasses overarching issues such as fiduciary duty, impact finances, taxonomy for sustainable activities and transition finance.

The Expert Panel has been held five times since the publication of the First Report in June last year. It continuously monitors the progress of measures outlined in the recommendations and discusses important issues.

There have been various developments over the past year, including initiatives by the FSA and other relevant ministries and agencies, as well as initiatives led by the private sector. It is important to summarize and communicate these developments, as well as new issues to be addressed and policies to be taken expeditiously.

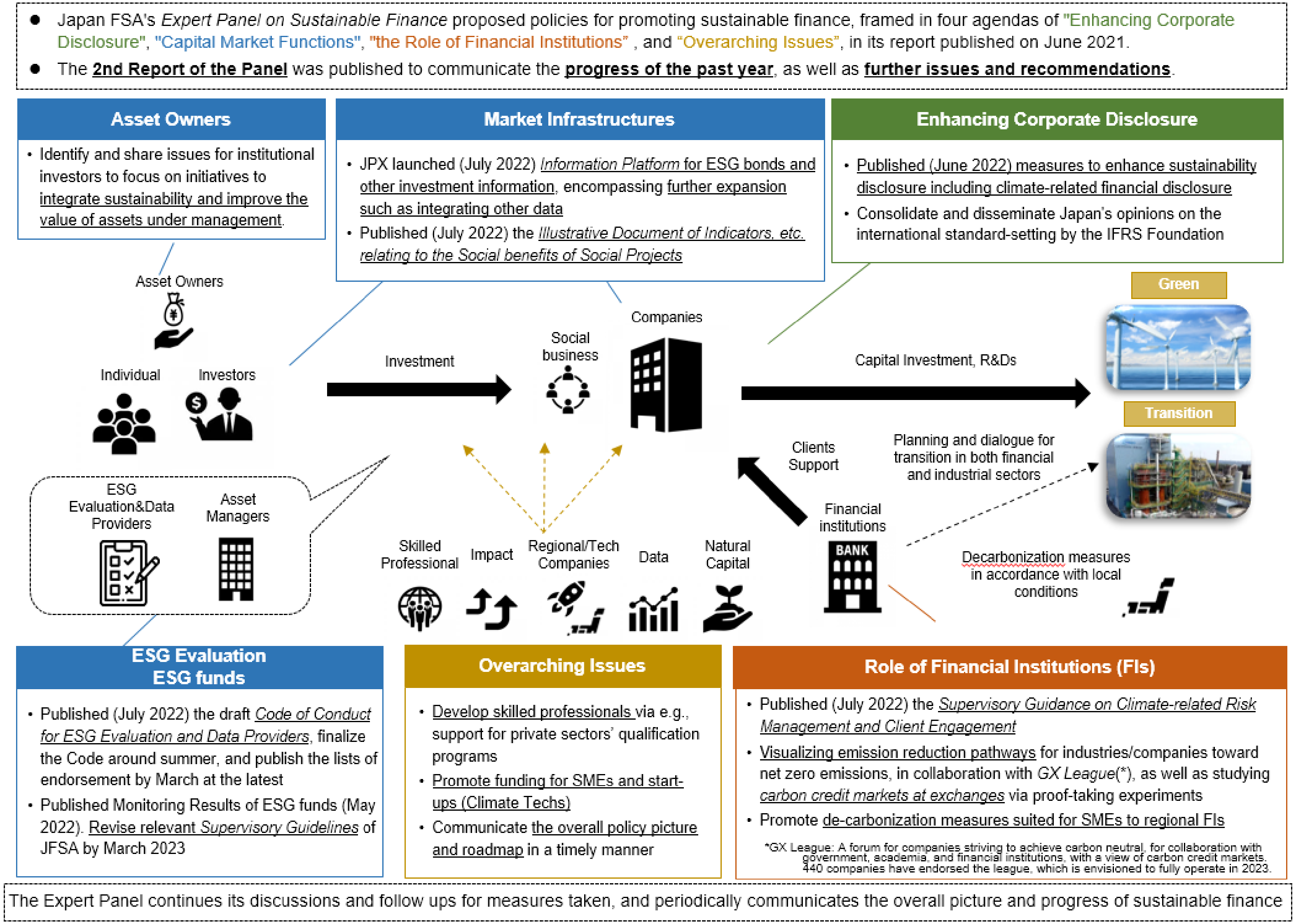
As the second report of the Expert Panel (hereinafter, the Second Report), this paper summarizes the current status of sustainable finance, development since June last year, and the direction of policy measures.

Since the situation and issues related to sustainable finance will continue to change significantly, and the Expert Panel will continue the discussion to gather information on the status of responses and issues in a timely and flexible manner, and encourage effective responses by relevant parties, such as collaborative responses by relevant ministries and agencies.

Furthermore, given that the promotion of sustainable finance is an international effort to address global issues, and that in particular, Japan will serve as chair of the G7 next year, the FSA should actively communicate and disseminate globally the issues discussed in the Expert Panel.

The below 2. summarizes various issues surrounding sustainable finance, including recent changes over the past year, and 3. summarizes the implementation status of measures and future issues.

(Figure 1) Overview of Sustainable Finance Initiatives



(Figure 2) Roadmap of Sustainable Finance Initiatives

2. Various issues surrounding sustainable finance

(1) Climate change and decarbonization

Over the past year, changes have continued in Japan and overseas, including decarbonization, with regard to various issues for the establishment of a sustainable economy and society.

With regard to climate change, the urgency of the issue is growing; the COP26[1] held last fall reconfirmed the significance of efforts to limit temperature increases to less than 1.5 ℃ during this century, and the IPCC[2] 6th Assessment Report indicates the need to peak out greenhouse gas emissions by 2025.

Regarding transition towards net-zero, which was listed as one of the overarching issues in the First Report, there has been a rapid increase in the movement of international coalitions of private sectors, before and around the time of COP26 to achieve carbon neutral by 2050.

The number of signatories in those coalitions, each for banks, insurers, asset owners and asset managers[3], and the Glasgow Financial Alliance for Net Zero (GFANZ) that brings these coalitions together, has increased over the past year, with around 20 Japanese signatories including three mega-banks and major life insurers, asset managers and securities companies.

Signatories are all committed to achieving carbon neutral by 2050, in terms of their Scope1 and 2 and Scope3 emissions. Signatories of NZBA are, for example, committed to set and announce, within 18 and 36 months of joining, corresponding interim targets of 2030 (or sooner) to achieve this goal[4].

Furthermore, for encouraging the target setting of signatories and their dialogue[5] with companies, NZAOA, NZBA and GFANZ, for instance, are discussing how FIs should set their Scope3 emissions targets, and how each industry should implement transition plans and pathways for achieving carbon neutral. It is conceivable that this will lead international discussions in the future.

In international discussions in the public sector, the G20 Sustainable Finance Roadmap[6], which was endorsed at the G20 Rome Summit in October last year, calls for developing a framework for transition finance by 2023.

G20 SFWG[7] is, taking into account the progress of discussions in the private sector as described above, working diligently to develop the framework and ensure the credibility of FIs' transition plans. At various international organizations collaborating with the SFWG, the IPSF[8], for example, established a transition finance working group in February this year, co-chaired by the European Commission, the Swiss Ministry of Finance, and the FSA (Japan), to develop principles.

In Japan, "Sector Roadmaps" have been formulated for seven new sectors[9] in the past year, in addition to that for international shipping that have already been announced, indicating the way forward for the use of technologies that contribute to emission

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[1] Held from October to November 2021
[2] Intergovernmental Panel on Climate Change
[3] Net-Zero Banking Alliance (NZBA), Net-Zero Insurance Alliance (NZIA), Net-Zero Asset Owner Alliance (NZAOA), and Net Zero Asset Managers initiative (NZAM), respectively.
[4] In Japan as well, some major FIs have already set and announced interim targets for their investments and loans for some industries by 2030 based on these commitments
[5] "Dialogue" and "engagement" shall be treated as having the same meaning, including hereafter.
[6] https://g20sfwg.org/wp-content/uploads/2022/01/RoadMap_Final14_12.pdf
[7] Sustainable Finance Working Group
[8] International Platform on Sustainable Finance
[9] Iron and steel, chemical, electricity, gas, oil, cement, and paper and pulp

reductions by industry. Examples of financing such as transition bonds and loans based on the roadmaps have been increasing.

Furthermore, in February this year, the Ministry of Economy, Trade and Industry (METI) announced the "GX League Basic Concept" as a forum for companies that consider decarbonization as an opportunity for economic growth to work together with government, academic and FIs, and discussions are now underway toward full operation from 2023 onwards. Companies participating in the GX League are expected to support 2050 carbon neutrality, formulate and announce interim targets for reduction by 2030 (including indirect emissions from business partners) that are consistent with 2050 net zero, as well as trade through a carbon credit market and work with a wide range of entities in the supply chain as well as with consumers and markets toward achieving the targets.

440 companies from a wide range of industries, including high-emission industries and financial companies, have expressed their support for the league. As the significance of the transition has been confirmed both domestically and internationally and various discussions are underway to ensure its effectiveness, dialogues between the financial and industrial sectors with a view to materializing emission reduction plans, including interim targets for 2030, are major issues ahead. Financial companies are expected to proceed constructive dialogue with real sector companies participating in the league, taking into account international discussions in GFANZ and elsewhere, in order to contribute to setting and implementing appropriate targets for themselves and their customers.

The importance of risk sharing between the public and private sectors has been pointed out internationally to effectively promote companies' efforts toward decarbonization (so-called blended finance[10]). The G20 Sustainable Finance Roadmap announced last October also mentions blended finance as a means to encourage multilateral development banks and other entities to mobilize private funds.

In order to realize the decarbonized society, the Japanese Government has stated in the "Basic Policies for Economic and Fiscal Management and Reform 2022" that in order to realize a public-private investment of more than 150 trillion yen over the next 10 years, it would manifest and make maximum use of the growth-oriented carbon pricing concept that would be effective in maximizing both growth promotion and emission control/capture. It also states that the Government will consider procuring government funds of sufficient size to lead public-private investment of more than 150 trillion yen in advance through "GX Economic Transition Bonds (tentative name)" backed by future financial resources and promptly providing investment support in a form foreseeable over multiple years.

(2) Biodiversity and natural capital

There are also various discussions on issues related to natural environments other than climate change.

With regard to biodiversity, for example, the TNFD[11] is advancing discussions to establish a framework for appropriately assessing and disclosing impacts, dependencies, and risks and opportunities related to natural capital and biodiversity and business

[10] A mechanism to provide funds by combining private and public funds with different risk-return preferences in fields such as development finance and impact investment.
[11] Taskforce on Nature-related Financial Disclosures

activities, taking into account the framework of TCFD[12] of climate change[13].

In March 2022, the Task Force released the first draft proposal for establishing a TNFD framework. The Task Force follows the same basic framework of TCFD, such as governance, strategy, and risk management, and suggests that biodiversity and other related risks be assessed and disclosed in an integrated manner within this framework. Also in June, the illustrative metrics for impacts related to business activities, dependencies was published in the second draft proposal.

As for marine resources, the United Nations Environment Programme Finance Initiative (UNEP FI)[14] has been advocating the sustainable use of marine resources as part of the "blue economy." This year, it published a report on the risks of marine mining and other activities related to finance. Also in January this year, the International Finance Corporation released guidance summarizing examples of uses of funds deemed to be "blue" based on the green bond principles for climate change issues[15].

With regard to natural capital and biodiversity, the FSA, with other regulators and in cooperation with relevant ministries and agencies, should deepen the knowledge through participating in the international discussions for developing the conceptual framework of relevant risks and opportunities and those for corporate disclosure at the TNFD forum.

(3) Governance and social issues

In addition to issues related to the natural environment, there are various governance issues such as corporate governance and anti-corruption, and social issues that encompass diverse content such as respect for human rights and diversity, and employment and labor practices. Discussions are advancing for each of these issues.

(Figure 3) Various ESG-related themes

12 Taskforce on Climate-related Financial Disclosures
13 In December last year, the Ministry of the Environment (MOE) and the FSA joined the TNFD Forum.
14 A joint activity between the United Nations Environment Programme and financial institutions to promote transformation into a financial system that integrates economic development and ESG considerations. Signed by over 200 financial institutions around the world, including 14 major non-life insurance companies and banks from Japan.
15 The International Finance Corporation (IFC) Guidelines for Blue Finance. Examples of "blue" financing include the development of equipment that contributes to the conservation of water resources, the establishment of purification facilities, the development of aquaculture and freezing technologies and processes for fisheries, and the development of biodegradable products

For example, with regard to respect for human rights, the UN Guiding Principles on Business and Human Rights marked its 10th anniversary March last year[16]. The Principles state that companies have a responsibility to respect human rights in their activities and value chains, and include the implementation of "human rights due diligence"[17].

The movement to legislate human rights due diligence is accelerating in Europe and elsewhere. Beyond that, not only companies are required to comply with the domestic laws and regulations of the countries in which they operate, but also their actions are being evaluated in light of international standards, etc., and they are required to conduct human rights due diligence by their business partners and investors.

In Japan, too, the government formulated an "National Action Plan on Business and Human Rights" in October 2020, and, in March this year, established the "Study Group on Guidelines for Respecting Human Rights in the Supply Chain" and started to develop cross-sectoral guidelines on human rights due diligence.

There are various other social issues, such as poverty and hunger, health and welfare, education, inequality, and gender equality. There are also issues such as dealing with the aging society and regional revitalization, especially in the case of Japan. One of the challenges is how each company should organize and give concrete shape to these various issues and concepts.

As described below, a publicized draft set of examples of indicators for disclosing “social benefits of social projects”, showing how social projects’ objectives and benefits could be expressed by issuers, could be referred to in this respect.

As another example, the Japan Business Federation presented, in order to encourage constructive dialogue for sustainable growth between companies and investors, the examples of 84 indicators of social benefits that would contribute to transforming business models or creating market opportunities[18].

In addition, new issues have arisen. International supply-and-demand pressures, energy price increases triggered by the invasion of Ukraine, and heightened energy and food security concerns may have wide-ranging impacts on trends in sustainable finance. While countries are developing new resources and facilities for stable energy supplies, there are also moves to reduce their energy dependence on Russia and other countries by accelerating the transition away from fossil fuels. Destabilization of food production and distribution, as well as rising food prices, are having global impacts, and international cooperation is increasingly needed. There are also various discussions on how to view and recognize sustainability issues as a whole, including security related industries including cyber security, the ideal way for independent food supplies, and working styles and other changes due to COVID-19.

(4) New Form of Capitalism

The Government regards the resolution of these various social issues as a central issue for the realization of the "New Form of Capitalism", and it is in line with the efforts to promote sustainable finance. The "Grand Design and Action Plan for the New Form of Capitalism" (hereinafter, the Grand Design) released in June this year states that the new public-private partnership will aim to solve social issues with large externalities that

[16] Adopted by the UN Human Rights Council in March 2011, grounded on 1) the state duty to protect human rights, 2) the corporate responsibility to respect human rights, and 3) access to remedy
[17] Identify, prevent, mitigate and account for how they address their impacts on human rights
[18] https://www.keidanren.or.jp/policy/2022/060.html

cannot be solved by the market alone.

In addition, the "Basic Policies for Economic and Fiscal Management and Reform 2022" adopted by the Cabinet in the same month positions initiatives aimed at solving social issues as a source of added value as a growth strategy. Through the medium- to long-term and planned implementation of focused investment and regulatory and institutional reforms through collaboration between the public and private sectors, the government aims to simultaneously solve issues and achieve economic growth while transforming the structure of the economy and society into one that is more resilient to changes and sustainable.

In particular, with regard to impact investment, which is listed as an overarching issue also in the Second Report, the Grand Design promotes investment in social entrepreneurs and impact investment by public and private sector funds (investment that aims not only to obtain economic benefits but also to solve social issues). In addition, with regard to social bonds, it also lists the development of reference indicators on page 21.

In addition, the Grand Design states investment in people and distribution, and calls for strengthening disclosure of non-financial information such as human capital and the gender pay gap. It is expected that the enhancement of corporate disclosure and constructive dialogue with investors will lead to the sustainable creation of corporate value.

As stated in the Grand Design, it is essential for a company to fulfill its social and environmental responsibilities (human capital, human rights, climate change, diversity, etc.) in order to keep its business sustainable.

The Second Report has been compiled under the title "Financial systems that open up a new sustainable society," in order to widely share such recognition and contribute to the formation of a new sustainable society.

3. Progress and challenges in sustainable finance initiatives

(1) Overview of initiatives and issues

Sustainable finance is about the role of finance in supporting changes in social and economic structures as a whole. It is important to comprehensively understand and examine values and issues related to players (fund providers/recipients, and intermediaries such as securities companies), types of funds (stocks, bonds, loans, equipment funds, start-up funds, etc.), target fields (environment, social, governance, etc.), and knowledge, human resources, and technologies that enable structural transformation of the society and the economy.

Figure 1 and 2 (page 2, 3) provides an overview related to sustainable finance, including the new issues that have emerged during the past year, based on the First Report.

At the center of the diagram are companies that are undertaking changes in industrial and social structures, as well as investors and FIs that provide funds to them. Companies are advancing various sustainability initiatives in response to changes in the natural and social environment. Proper disclosure of these initiatives will enable investors and FIs to accurately understand the risk, growth potential and sustainability of their businesses in the future and lead to investment and financing.

Institutional investors (asset owners / asset managers) and individual are listed as providers of funds to companies.

From the perspective of achieving a sustainable economy and society as well as risk management, institutional investors are expected to provide necessary funds from a medium- to long-term perspective and play a role in disciplining corporate management. Institutional investors need to accumulate knowledge on ESG issues, their impact on business, and technologies to resolve them, in order to expand the range of companies that are advancing sustainability initiatives and to engage in effective dialogue with companies.

Among institutional investors, it is important for so-called asset owners[19] to further deepen their knowledge about how sustainability initiatives should be considered in their basic investment policies in order to grow assets under their management and expand benefits for the ultimate beneficiaries of the assets (see p14, 15).

Asset managers are required to contribute to improving the benefits of asset owners by enhancing their knowledge of sustainability considerations, appropriately understanding investee companies, and ensuring assets' growth and sustainability, while taking into account the asset owners' basic investment policy regarding consideration of ESG issues.

Individuals with approximately 2,000 trillion yen in financial assets play a part in the sustainable finance market as individual investors by purchasing investment trusts, etc., and are also the ultimate beneficiaries of the assets held by institutional investors. As pointed out in the First Report, the opportunities for individual investors to choose their own ESG-related financial products are increasing, and it is important to carefully explain the establishment and sale of ESG-related investment trusts in order to expand investment opportunities for individual investors. To this end, the perspective of sustainable finance needs to be incorporated into individual financial education. (see p30).

In order for the market as a whole to function properly, the role of various intermediaries, which professionally mediate between institutional investors and

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[19] Here, institutional investors are conveniently classified into asset managers (such as investment management companies) who are entrusted with the management of funds and invest in companies themselves, and asset holders (such as pension funds, insurance companies, corporations) who are the providers of such funds.

companies, including securities companies, is essential. Asset managers also play such roles, and it is necessary to develop a management framework so that investors can correctly understand the investment policy and portfolio characteristics of investment trusts that take sustainability into account by enhancing their professional perspective. (see p16, 17)

Equally, ESG evaluation and data providers need to appropriately communicate with companies using appropriate data and to ensure the transparency and independence of the evaluations they provide, so that investors can accurately understand the various sustainability initiatives of companies. (see p18, 19)

In addition, it is important to develop infrastructure for the effective functioning of the market as a whole, encompassing companies, investors, and intermediaries including securities companies, etc.

The First Report refers to the efforts of overseas stock exchanges to aggregate ESG-related information and recommended the establishment of the "information platform" for ESG bonds and their issuance cases. Based on this, Japan Exchange Group (JPX) is preparing to launch the platform by the middle of 2022. In addition, as discussions on corporate disclosure related to sustainability advance both in Japan and overseas, how to aggregate and enhance corporate data based on these discussions and practices would be key future issues. (see p20)

It is also important for FIs, which have close ties with companies, to properly exercise their functions. As it is extremely important for companies, particularly in high-emission industries, to steadily progress their transition efforts toward decarbonization, FIs have essential roles of continuously engage in dialogues with their clients and make decisions on investments and loans to realize decarbonized structural reforms, taking into account domestic and overseas policies, and measures taken by global industries and FIs. (see p23-25)

In addition, there are overarching issues such as transition, carbon credit market, impact, regional and tech companies, data-aggregation, and development of skilled professionals. All of these issues involve various entities, and it is essential to work on a wide range of cooperation. It is also important for the FSA, from the perspective of improving the knowledge of working-level professionals throughout Japan, to enhance the provision of information to various generations, including the younger generation and to engage in dialogue with a wide range of stakeholders. (see p26-31)

As described above, considerable progress has been made in the areas of enhancing corporate disclosure, capital market functions, and the role of FIs. As the measures progress, however, further challenges have arisen in each of these areas, and it is necessary to continue and deepen measures to address them.

Given the situation in which the basic needs and structure of policies have not changed significantly and responses are required to be deepened and expanded, the Second Report maintains the basic structure of the First Report and sets out, in addition to existing three pillars of enhancing corporate disclosure, capital market functions, and the roles of FIs, promoting the transition, overarching issues such as supporting the start-up of climate-tech companies, developing data, and expanding knowledge.

As issues and necessary measures related to sustainable finance are expected to change continuously in the future, we at the Expert Panel would update and disseminate the progress status of sustainable finance, including changes in issues, on the FSA website and elsewhere in a timely manner.

(2) Enhancing corporate disclosure

As issues related to the sustainability of the economy and society become increasingly serious, it has become essential for companies to consider what risks and opportunities these issues pose to business activities and formulate strategies to address them in order to maintain and improve corporate value over the medium- to long-term.

It has become more important than ever for investors, FIs and various stakeholders including business partners and workers, to take a proactive view of the changes in the external environment, verify the resilience of strategies, and link them to growth.

In addition, promoting constructive dialogue between investors and FIs and companies by making use of sustainability information disclosure, including non-financial information, would contribute to improving the functions of the entire investment chain.

From this perspective, the First Report states that Japan should actively take part in discussions at the IFRS Foundation toward the foundation of international sustainability disclosure standards, and that the FSA enhance the quality and quantity of corporate disclosure based on the TCFD and continuously proceed examination for enhancing disclosure of information related to climate change.

The IFRS Foundation established the International Sustainability Standards Board (ISSB) last November and published a prototype of disclosure standards for sustainability with a focus on climate change in the same month. Subsequently, in March this year, public consultation was held on an exposure draft of the standards, with the aim of finalizing the standards by the end of the year.

In Japan, the market structure reforms has been implemented by the TSE (Tokyo Stock Exchange) from April this year, and the Prime market was launched. For companies listed on the Prime Market segment of TSE, the Corporate Governance Code stipulates that they should "enhance the quality and quantity of disclosure based on the TCFD recommendations, which are an internationally well-established disclosure framework, or an equivalent frameworks" and based on this, measures are being taken for enhancing corporate disclosure.

In response to a request from the Minister of State for Financial Services in June last year, the Financial System Council of FSA established the Working Group on Corporate Disclosure in response to the rapidly increasing importance of sustainability in corporate management and investors' investment decisions. In September last year, the Working Group began deliberations on corporate sustainability disclosure, and in June this year, it published a report (Report by the Working Group on Corporate Disclosure, hereinafter, the Disclosure Working Group Report)[20].

In the Disclosure Working Group Report, disclosure of sustainability information, including measures to address climate change, is positioned as one of key items in the disclosure of corporate information, and in light of the need to continuously improve the content of sustainability disclosure, a new section for disclosure of sustainability information will be created in the Annual Securities Reports (hereinafter, ASRs).

According to Disclosure Working Group Report, this new section in the ASRs shall be disclosed based on the four components of "Governance," "Strategy," "Risk Management," and "Metrics and Targets," consistent with the international framework. The Disclosure Working Group Report also stipulates;

[20] https://www.fsa.go.jp/singi/singi_kinyu/tosin/20220613.html

- that all companies should disclose "Governance" and "Risk Management" from the viewpoint that companies need a framework to recognize sustainability information and judge its importance based on the impact on their business type, business environment, and corporate value,
- and that although disclosure of "Strategy" and "Metrics and Targets" is desirable, each company should judge their importance and disclose them through its "Governance" and "Risk Management" framework.

It is also important for the Sustainability Standards Board of Japan (SSBJ) to play a central role in gathering domestic disclosure practices, expectations and opinions of investors, and internationally disseminating opinions from Japan in response to the international movement to develop sustainability disclosure standards.

Furthermore, from the perspective of ensuring international comparability, the SSBJ should promptly consider specific disclosure contents based on the standards established by the ISSB, and such specific disclosure contents could then be added to the new section in the ASRs mentioned above.

As described on page 7-8, discussions toward realizing "New Form of Capitalism" focus on the importance of investing in people. In recent years, institutional investors have focused on human capital and diversity as information related to long-term corporate value, and discussions on the disclosure of information on human capital have been advancing internationally. In light of this situation, the Disclosure Working Group Report stipulates that, for providing information necessary for investors' investment decisions, the followings will be added as disclosed items in the ASRs:

- "Human resource development policies" and "Policies on improving workplace environment," taking into account the importance of human resources strategy for medium- to long-term enhancement of corporate value
- In accordance with the circumstances of each company, the establishment of measurable metrics (input, outcomes, etc.) consistent with the above "Policies", as well as targets and progress status for these metrics
- "Ratio of women in managerial positions, " "Ratio of male workers taking childcare leave, " and "Gender pay gap, " published in accordance with the framework of other relevant laws

Based on the Disclosure Working Group Report, the FSA is expected to revise regulations expeditiously, and future discussions are expected on how to clarify the roles of the SSBJ and how to enhance the assurance of sustainability information.

(3) Capital market functions

a) Institutional investors (asset owners and asset managers)

Institutional investors are expected to provide, as well as to consider business risks of investee companies due to industrial structure changes accompanying decarbonization, necessary funds from a medium- to long-term perspective, support companies addressing sustainability initiatives, expand their base, and encourage companies to discipline their management so that they can increase growth and sustainability of their assets.

In particular, as decarbonization becomes an important element for growth and the government proceeds its efforts to realize green transformation, it is important for investors to focus on sustainability of companies from a broad perspective of securing medium- to long-term investment returns.

From this perspective, the First Report points out that institutional investors should enhance their commitment to the active promotion of ESG investment and engagement, such as endorsing the Stewardship Code, signing PRI[21] and disclosing information based on TCFD, and work to build organizational systems or develop human resources for effective dialogue with companies, and actively participate in an international initiatives.

In Japan, the number of signatories to the Stewardship Code has increased to 322 as of the end of May this year, and the number of signatories to the PRI, mainly institutional investors, has more than doubled in the past five years. Along with TCFD-based disclosure required for TSE Prime Market-listed companies from April this year, institutional investors are now more clarifying their investment and engagement policies and deepening their dialogue with companies.

In addition, participation in international efforts by institutional investors to mutually support the establishment of investment policies and engagement are expanding. For example, five major life insurance companies have joined the NZAOA, which had only one company at the time of the publication of the First Report in June last year.

On the other hand, it has been pointed out that investment strategies including consideration of ESG issues vary among asset owners and that there are challenges for some asset owners, including the development of management frameworks.

Companies are advancing various sustainability initiatives, such as decarbonization of production and distribution, improvement of working conditions for employees, and leadership reforms. Equally, it has been pointed out that the ultimate beneficiaries of assets, such as employees of companies, are increasingly interested in considering sustainability that contributes to the long-term growth of assets under management, along with the growing momentum for the SDGs. It is important to enhance the provision of information that will improve the knowledge of interested ultimate beneficiaries and to understand their intentions.

It is important for institutional investors, especially asset owners, to deepen their knowledge about how sustainability initiatives need to be considered in their basic policies on investment from the perspective of increasing the growth and sustainability of assets under their management and expanding the benefits for the ultimate beneficiaries over the long term.

Consideration of ESG factors in investments, such as ESG integration[22], is spreading among institutional investors in Japan amid the increasing influence of decarbonization

[21] Principles for Responsible Investment, which offer a menu of possible actions for incorporating ESG issues into investment practice (launched in 2006)

[22] In general, incorporating ESG factors into investment decisions.

on corporate strategy. It is important for a wide range of institutional investors to deepen their understanding through mutual discussions on how to practically consider ESG issues in formulating investment policies and product selection.

On the other hand, with regard to asset owners in particular, there are various entities, including beneficiaries and the characteristics of underlying contracts and assets, such as individual companies' corporate pensions, mutual aid associations to which national and local government employees belong[23], and life insurance companies that manage funds of life insurance policyholders. The actual state of asset management and investment varies among them.

For this end, for example, various asset owners, asset managers, competent ministries and agencies, experts, international organizations, etc. may, in close cooperation, identify and share current issues for asset owners to focus on efforts to improve the growth and sustainability of investee companies and continuously increase their assets under management.

In conducting such discussions, it is also important to broaden understanding that the relationship between asset owners' consideration of ESG issues and fiduciary responsibilities, which is outlined in the First Report.

[23] Federation of National Service Personnel Mutual Aid Association and Pension Fund Association for Local Government Officials, respectively.

b) Opportunities for retail investor

Amid growing interest in ESG and SDGs, ESG-related publicly offered investment trusts (hereinafter ESG investment trusts) have been set up one after another, attracting attention. On the other hand, concerns have been raised that these investment trusts may mislead investors as their actual investment processes largely differ, despite calling for environmental considerations (issues so-called Green Washing)[24].

While asset management companies adopt various ESG investment methods, investment trusts in Japan generally aim at the growth of trust assets, not directly at the creation of environmental and social effects as in impact investments. In addition, some investment companies do not necessarily consider ESG factors as a source of excess returns when selecting investment issues, but consider them only as an element of corporate analysis. Furthermore, asset management companies vary in the consideration of ESG factors when selecting investment issues and in the depth of engagement activities thereafter.

The discrepancy between the actual status of these various types of ESG investment trusts and general investors' expectations for ESG investment trusts is considered to be one of the causes of the Green Wash problem. For this reason, asset management companies engaged in ESG investment are expected to formulate their own clear ESG policies and continuously work to enhance their investment processes, while establishing organizational structure necessary for implementing appropriate ESG investment.

Furthermore, the asset management companies are expected to actively provide appropriate information and disclosure, in a manner consistent with the actual investment process, so that investors can correctly understand the details of investment products without misunderstanding and make appropriate investment decisions by comparing them with other products.

Since November 2021, the FSA has conducted a survey of 37 domestic asset management companies that handle 225 ESG funds, focusing on their organizational structure, positioning of ESG investments, investment strategies and processes, implementation status of engagements, and disclosure status. In May this year, the FSA compiled "Supervisory expectations for asset management firms providing ESG funds"[25] Based on this report, the FSA will continue dialogue with asset management companies from the viewpoint of protecting investors and realizing the development of sound markets, and will take necessary measures with respect to the amendment of the Guidelines for Supervision by around the end of fiscal year 2022.

[24] Pretending as if consideration is being given to the environment even though there is no environmental improvement effect.

[25] Progress Report on Enhancing Asset Management Business 2022 (FSA May 27, 2022) https://www.fsa.go.jp/en/news/2022/20220527.html

(Reference) Supervisory expectations for asset management firms providing ESG funds
from *Progress Report on Enhancing Asset Management Business 2022*

In cases where an asset management firm states, for example, "ESG factors are taken into account" as an explanation of the characteristics and investment process of ESG funds it provides, the FSA expects that the firm will improve the matters described in each of the following items.

1. Overarching principle

The investment process and approach should be further strengthened on a continuous basis, and clear explanations and disclosures should be made in a consistent manner based on the investment process so that investors can make appropriate investment decisions.

2. Organizational structure

A firm should develop effective systems for ESG investment including the establishment of a department responsible for strengthening the sustainability promotion framework enhancing ESG investment methods, and applying ESG experts.

3. ESG integration

In order for ESG analysts and investment teams to accurately share the details and reasons of ESG evaluation of individual companies, and appropriately estimate corporate value and engage with companies, fund managers should not rely solely on their own judgment, but also should take systematic measures to ensure consistency and continuity as an organization.

4. ESG rating and data product provider

In order to conduct in depth corporate research and analysis, appropriate verification of ESG ratings and data product providers should be conducted from the viewpoint of ensuring the accuracy and quality of ESG evaluations and individual data provide d by the providers.

5. Stewardship Activities

In accordance with its investment strategy, a firm should proactively conduct stewardship activities to achieve corporate value growths by improving ESG related business opportunities and reducing business risks identified at the time of investment.

6. Disclosure

In order for investors to correctly understand the details of investment products without misunderstanding and make appropriate investment decisions by comparing them with other products, appropriate information provision and disclosure should be promoted in a consistent manner that conforms to its investment process.

7. Outsourcing

From the viewpoint of fulfilling fiduciary responsibilities, outsource d investment managers should be appropriately managed and accurate information should be provided to customers in accordance with the characteristics of products.

c) ESG evaluation and data provider

As sustainable finance expands globally, the role of "ESG evaluation and data providers" that collect, provide, and evaluate information on companies' ESG initiatives is increasing.

The First Report pointed out there have been numbers of issues regarding ESG evaluation and data providers, such as the transparency and fairness of evaluation, governance and impartiality, the appointment of human resources, and the burden on companies, and that the FSA should actively participate in international discussions at International Organization of Securities Commissions (IOSCO) and discuss the code of conduct for ESG evaluation providers, etc.

In response, the Technical Committee for ESG Evaluation and Data Providers, etc. (hereinafter, the Technical Committee) was established under the Expert Panel. The Technical Committee held a total of seven discussions and compiled and published a report in July.

From the perspective that it is important to improve the environments throughout the investment chain in order for ESG evaluation and data to be used in a reliable manner, the report includes recommendations to investors and companies in addition to those to ESG evaluation and data providers.

In light of the fact that the scope or methods of ESG data and evaluation service have varieties, and that those are expected to continue to change significantly in the future, possibly through the enhancement of corporate disclosure, etc., the recommendations are described on a principles-based basis so as to ensure flexibility based on the originality and ingenuity of each entity.

Based on this, with respect to the recommendations in the report that relate to ESG evaluation and data providers, for which there are currently no specific regulations and supervision by the authorities does not extend, the FSA will draw up the "Code of Conduct for ESG Evaluation and Data Providers" through public consultation and will call on each provider to support, through the so-called "comply or explain"[26] approach.

The recommendations are based on the report published by the IOSCO[27] in November last year, and are rather enhanced in light of the recent situation in which the importance of the evaluation of ESG-related bonds and loans is increasing.

The first of the recommendations is to secure service quality. Following this are: securing human resources necessary to ensure quality (Principle 2); ensuring independence and managing conflicts of interest, which are prerequisites for ensuring quality (Principle 3); ensuring transparency (Principle 4) and confidentiality (Principle 5), which are essential for ensuring quality and reliability. In particular, the development of human resources related to ESG (Principle 2) has been added as an independent principle referring to IOSCO's report.

In addition, Principle 6 (communication with companies), states that a contact point for communication with companies should be established and appropriate responses should be made to important or reasonable issues raised.

With regard to the scope of ESG evaluation and data provision that should be subject to the Recommendations and Codes of Conduct, the report proposes that "evaluation" and "data provision" should be integrated and defined as "ESG evaluation and data provision," including data provision, while devising a definition.

[26] FSA calls for organizations to express its support for the Code via public announcement, and the organizations supporting the Code will either they comply with the principles and guidelines of the Code, or explain the reasons why they do not comply with a particular item.

[27] IOSCO「Environmental, Social and Governance (ESG) Ratings and Data Products Providers」 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

There are at least two business models for ESG evaluation organizations: one is to evaluate a company and the user of the evaluation service bears the cost, and another is to evaluate bonds and the issuer of the bonds bears the cost. Given the increasing importance of bond evaluation both domestically and internationally, the report explicitly includes both business models as the subject of the proposal[28].

Overall, the report is written on a basis that based on the diversity of ESG evaluations and services provided, it is not necessarily a problem if evaluation results differ from one provider to another, and that it is more important that the basic concept of evaluation quality is clarified, which will increase the understanding of investors and companies and lead to improvement of initiatives in the market as a whole.

In order to ensure the reliable use of ESG evaluation and data, the report stresses the importance of actions by not only ESG evaluation and data providers, but also companies and investors. In this way, the Technical Committee has compiled recommendations for companies and investors so that market participants can engage in dialogue and cooperate with each other to improve the overall market in a mutually beneficial manner. It also encourages dialogue among market participants in various ways.

Going forward, the FSA should call for endorsement of the Code of Conduct from domestic and foreign evaluation providers that provide services in Japan, while holding public consultations, and publishing the status of support and endorsement in a comprehensive manner. The FSA should also actively disseminate the recommendations to investors and companies through related organizations, and consider opportunities to deepen understanding among market participants.

The Expert Panel will follow up on whether the recommendations and the Code of Conduct need to be revised further, while taking into account developments in the sustainable finance.

[28] So called Subscriber Pay model, in which an ESG evaluation is conducted and provided on an equity or company-by-company basis, and investors and other users of the evaluation and data bear the costs; and Issuer Pay model, in which the company issuing the bonds bears the costs of issuing the bonds and assesses the consistency with various guidelines on the bonds to be issued.

d) Information platform

As an infrastructure for the effective functioning of the market as a whole, the First Report identifies issues such as building an information platform for ESG-related bonds, gathering corporate sustainability-related data, and establishing a framework for objectively certifying the eligibility of ESG-related bonds.

In response to the First Report, JPX set up the Sustainable Finance Platform Development Working Group in October last year, then compiled and the Interim Report of the Working Group in January this year[29].

The Interim Report points out that ESG investment requires a wide range of ESG-related information, in addition to transaction information such as issue prices, compared to general stock and bond investments, but that such information is fragmented at present. Based on this, JPX plans to launch an "Information Platform" by around the middle 2022 to aggregate issuance information on bonds, etc., ESG strategies of issuers, information on external review, and ongoing reporting information including impact.

Additionally, the Interim Report clarifies that JPX aims to expand the provision of educational content on Information Platform for better understanding of practitioners and broader scope of the content. The Interim Report also states that JPX will, as one of the essential elements of the future Platform, consider compiling corporate ESG-related information and data.

As for the platform, it is desirable to gradually expand the scope of data aggregation to other financial products, such as ESG-related investment funds, not just ESG bonds, while improving user convenience (UX). As for corporate information, the Expert Panel expects that ESG data of companies, such as greenhouse gas emissions, will also be aggregated sequentially and the platform to become the hub for Japan's ESG investment.

In particular, with regard to corporate sustainability information, it is expected that disclosure will be enhanced in the future, taking into account discussions at the ISSB, SSBJ, and the Financial System Council's Working Group on Corporate Disclosure (see p12). Based on these developments, it is expected that corporate data will be aggregated on the platform, in cooperation with disclosure information systems.

[29] https://www.jpx.co.jp/news/0090/20220131-01.html

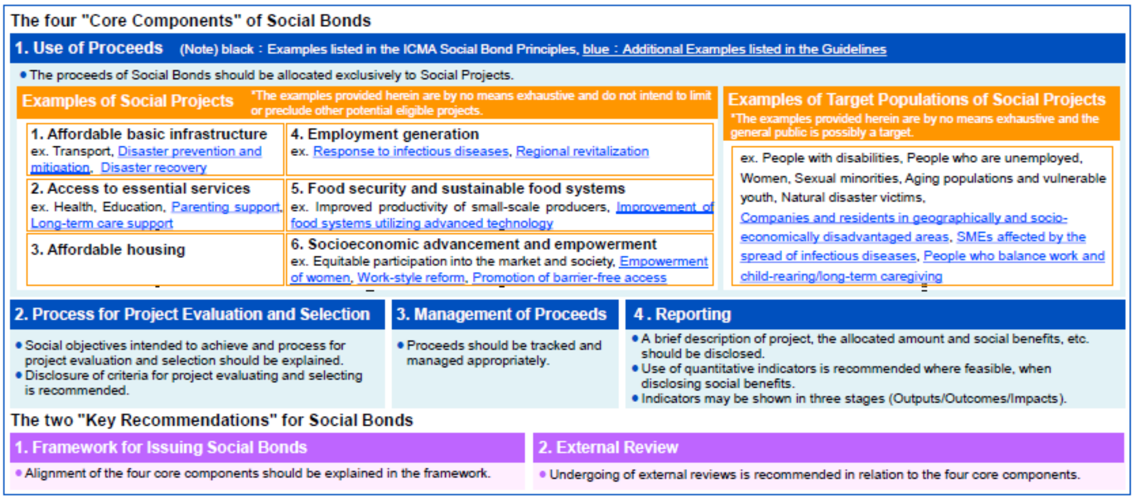
e) Social bonds

In addition to various environmental issues such as climate change, ecosystems and biodiversity crises, and marine plastic problems, there are various sustainability issues such as poverty, hunger, health and welfare, education, disparities, and gender equality as social issues, as well as issues such as dealing with the aging society and regional revitalization[30].

As issuance of social bonds[31] to raise funds for solving these social issues is expanding globally, issuance by the public sector in Japan has been expanded, while issuance by private companies has only just begun, and there were calls from the business community to develop detailed practical guidelines that are appropriate to the situation in Japan. In light of this, "Working Group on Social Bonds" was established under the Expert Panel in March last year.

Based on the discussions and public comments at the Working Group, the FSA finalized and published the "Social Bond Guidelines" in October last year, taking into account the consistency with the International Capital Market Association (ICMA)'s Social Bond Principles, which is an international standard, and also corresponding to Japan's situation that it has particularly many issues developed countries are facing.

(Reference) Outline of the Social Bond Guidelines



While the Guidelines state that issuers should disclose the social benefits of social projects using appropriate indicators when issuing social bonds, private companies have only just started issuing social bonds, and there has been insufficient accumulation of examples of disclosure using indicators.

To this end, the "Sub-Working Group of Relevant Ministries and Agencies on Impact Indicators, etc. for Social Projects" was established under the Working Group in December last year. It proceeded with the preparation of *the Illustrative Document of Indicators, etc. relating to the Social benefits of Social Projects* so as to serve as a

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[30] The Social Bond Guidelines define social issues addressed by social projects as "those that hinder, damage or threaten the well-being of society or a specific target population" and state that "While social issues can change from time to time, the social issues addressed by Social Projects should be those that are objectively recognized by a particular society." Then, with regard to understanding social issues, they state that "consideration may be given to international agreements … as well as the SDGs Action Plan, etc. in the context of Japan in particular."

[31] Bonds for which proceeds are allocated only to social projects (those that contribute to solving social issues and bring about social benefits)

reference for issuers to disclose social benefits, and the FSA published the draft of *the Illustrative Document* in May this year.

The Illustrative Document provides 17 examples of specific social projects that address social issues in Japan, elaborates the process by which the social benefits of the projects reach their impacts in each example, and provides examples of indicators used to show the social benefits at each stage of output, outcome and impact.

The draft *Illustrative Document* will be finalized through the public consultation process, and it is expected that the issuance of social bonds by private companies will be promoted through further dissemination of the guidelines including the document.

It is desirable that this *Illustrative Document* be disseminated internationally as a compilation of efforts to resolve issues in Japanese society, many of which are also common to advanced countries, while spreading it to market participants such as companies, securities companies, and ESG evaluation and data providers. Based on this, going forward it is possible to consider updating and reviewing it as necessary in light of changes in social issues.

The examples of social issues in this document would be useful not only for bonds but also for loans from the perspective of realizing social benefits through financing and project implementation. Initiatives such as SDGs-related loans that support companies that widely address SDGs issues are increasingly seen in Japanese local finance markets such as those conducted by regional banks, and it is expected the *Illustrative Document* will be disseminated widely as a reference for setting the outputs and outcomes of projects to which such loans are provided.

(4) Role of financial institutions

In Japan, where FIs accounts for a fair proportion in financial markets and plays essential roles for engagement with businesses, the roles of FIs are of great importance.

For FIs, climate-related risks can have significant impacts as the shifts in industrial structure in response to decarbonization may pose significant business risks to their clients. It is important for FIs to promote constructive dialogue with client companies proactively, leading to mitigation of transition risks and creation of new opportunities.

Therefore, the First Report calls for the FSA to set a guidance, which includes supervisory viewpoints regarding the development of climate-related risk management systems with the use of scenario analysis and the engagement in dialogue with companies, based on their size and characteristics. The First Report also calls for the FSA to support initiatives toward sustainable regional economic growth given that addressing climate change by Small and Medium-sized enterprises (SMEs) has become important.

With regard to climate-related risk managements, it is important for FIs to consider the necessity of improving existing risk management frameworks while monitoring international discussions and progress in risk management methods and practices. For risks that will become apparent over the medium- to long-term, it is important for FIs to assess how climate-related risks will affect risks in each category with taking their business strategies into consideration, and to respond to them[32].

It is also vital to tackle with physical risks such as a rise in the frequency and severity of disasters. For example, the Bank of England's exploratory scenario exercise on climate risk on major UK banks and insurers published in May[33] gauges the impact of physical risks on the FIs and the economy especially in the event where decarbonisation measures are not fully implemented, and encourages FIs to develop climate-related risk management system accordingly.

In July this year, the FSA published its "Supervisory Guidance on Climate-related Risk Management and Client Engagement" (hereinafter, Guidance), which lays out, based on the internal discussions at Basel committees and NGFS[34], its viewpoints of supervisory dialogues between the FSA and FIs with regard to developing FIs' management framework for making strategies on climate change, identifying and assessing risks and opportunities, and addressing risks. As for scenario analysis, in particular, large-sized FIs are strongly encouraged to continuously improve their methods.

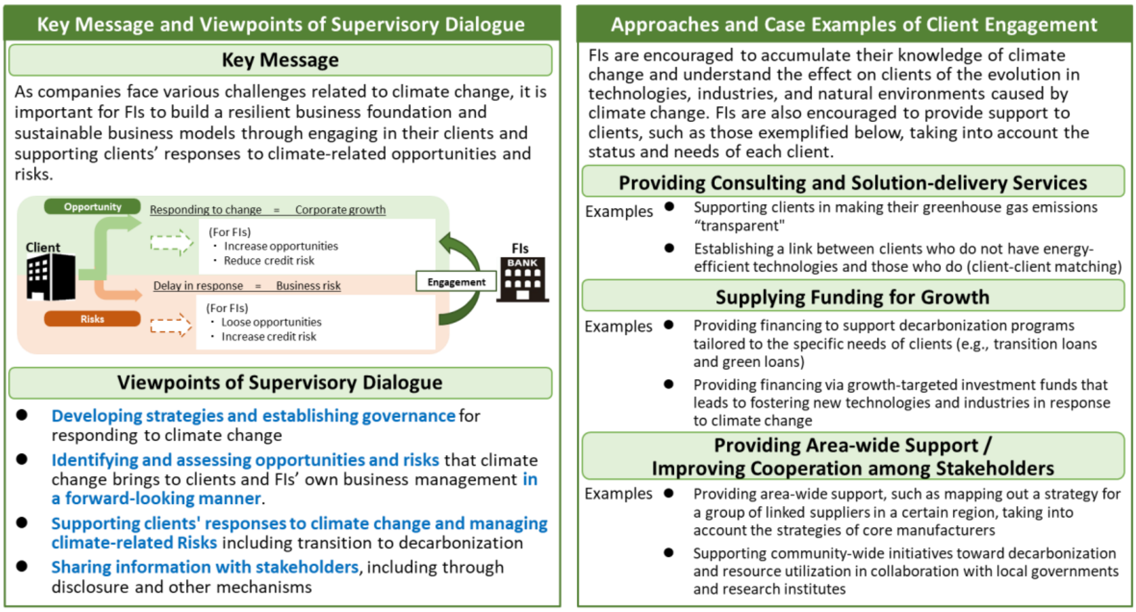
From the perspective of building sustainable business foundations resilient to climate-related changes, the Guidance stresses the importance of dialogue and support for local businesses. It encourages FIs to reflect on changes in local industry, technology, and the natural environment, identify the risks and opportunities of their clients related to climate change, and provide broad-based support.

[32] Risks related to financial institutions generally fall into categories such as credit risk, market risk, liquidity risk and operational risk. Climate-related risks do not add new risk categories, but are positioned as "risk drivers" that increase or decrease risks in each risk category through the various channels described above, starting with changes related to climate change.

[33] https://www.bankofengland.co.uk/stress-testing/2022/results-of-the-2021-climate-biennial-exploratory-scenario

[34] Network for Greening the Financial System

(Reference) Overview of the Guidance, published in July 2022



The Guidance will serve as a basis for supervisory dialogue between the FSA and FIs regarding responses on climate change. Based on the Guidance, the FSA should take specific actions, in order to make the risk management and the client support initiatives of large and regional FIs more effective[35].

With regard to scenario analysis, the FSA, in cooperation with the Bank of Japan, is currently conducting a pilot exercise with large-sized FIs. It is important for the FIs to continuously improve the scenario analysis so that they can utilize the analysis to develop their business strategies and support their clients, while addressing the data and methodological limitations identified in the exercise.

To this end, the FSA should actively participate in international discussions on the development of scenario analysis, and deepen discussions with FIs on the data, methods, and specific applications of scenario analysis based on international discussions and practical developments.

In addition, it is expected that FIs, especially for those participating in the net zero coalitions will accelerate the setting of interim targets for a net zero, however, details of target-settings are still under discussion internationally and in trials phases domestically. It is thus important to encourage FIs to establish a perspective on the target setting and take actual steps in order to achieve the target, by promoting discussions among FIs and collaboratively working with relevant ministries and agencies for further measures to help FIs and companies work together on building and implementing the targets[36].

As efforts to decarbonization are accelerating in local areas including global companies' calls for their supply chains, it will be an issue for local companies to

[35] The Guidance is intended for banks and insurance companies. For cooperative financial institutions it states that "it can be used as a reference when promoting initiatives related to climate change responses such as supporting client companies."

[36] the Japanese Bankers Association (JBA) set out the "Carbon Neutrality Initiative", which identifies the JBA's key policies and priorities up to 2030 to further strengthen the efforts of the Japanese banking industry toward achieving carbon neutrality
https://www.zenginkyo.or.jp/en/news/2021/121601/

cooperate with area-wide stakeholders and take measures according to the actual conditions of each industry and region.

SMEs in particular have various business situations and impacts, and it is important to consider measures according to the actual conditions of each industry, region, and individual enterprise, such as steadily sharing energy and switching energy sources, while proceeding with measures that can be taken at present, such as checking energy use and energy conservation.

Regional FIs are faced with the challenge of advancing initiatives to support clients while taking into account the actual conditions of industries, regions, and individual companies as well as cooperating with other FIs, local governments, and economic organizations. They also need to improve their knowledge in order to do so.

From this perspective, it is important for regional FIs, in cooperation with local governments and other local stakeholders, to identify risks and opportunities arising from decarbonization in the areas where they are based, and to actively identify issues.

On the other hand, regional responses and analyses are still in the process of development overall, and many regional FIs may have worries about specific responses.

For this reason, it is important for the FSA to proactively engage in discussions with stakeholders in each region on the significance of decarbonization initiatives, specific examples of initiatives, and the concepts of the above guidance, in cooperation with the relevant ministries and agencies.

At the same time, it is important to collect and share specific local issues and examples of initiatives and know-hows. Those which meet the needs of each company should be shared by an easy-to-understand manner in cooperation with industry associations, so that they can encourage local new ideas and opportunities.

For example, the MOE's Study Report on Financed Emissions Measurement introduces methods and specific examples of how to consider climate change-related risks and opportunities by calculating and analyzing emissions of clients (financed emission), and the ESG Regional Finance Promotion Program also shows various examples of supports regional FIs' provides to local companies[37].

[37] Ministry of the Environment, "Study Report on Financed Emissions Measurement" (April 22, 2022) and " Practical Guide to ESG Regional Finance 2.1" (March 2022)

(5) Overarching issues

a) Fiduciary duty

Regarding the relationship between ESG investment and fiduciary duty[38], the First Report summarizes that the recognition that ESG investments do not run counter to fiduciary duty has gained a fair degree of international support, and rather considering ESG factors from the view point of sustainable finance can rather be positioned as a desirable response in fulfilling fiduciary duty.

As stated above, it is important for asset owners to deepen their knowledge about how sustainability should be considered in their investment and financing policies from the viewpoint of increasing the growth and sustainability of assets under their management and expanding benefits for beneficiaries. As part of sharing such knowledge, sharing and disseminating the basic structure of fiduciary responsibilities is still important.

It is necessary for the FSA to discuss and disseminate issues related to sustainability considerations in cooperation with asset managers and competent ministries and agencies.

b) Taxonomy and transition, carbon credit

With regard to the development of criteria for classifying "sustainable" economic activities ("taxonomy"), which is being discussed in several countries including the EU, the First Report points out 1) that there would be effect in those measures of preventing so-called green wash and promoting sustainable finance, at the same time 2) that there would be challenges to ensure the effectiveness, such as appropriate scientific basis, cost of setting centralized standards, consideration of alternative measures such as utilization of market-based ESG evaluation, and consideration of the stage and conditions of each country.

Internationally, in November last year, the IPSF published a "Common Ground Taxonomy" report and an annex that compared the taxonomies of the EU and China and extracted commonalities. In addition, in the roadmap published by the G20 in October last year, it is pointed out that improving the comparability and interoperability of measures to realize investments in line with sustainability goals, such as taxonomy, is an issue.

As mentioned above, JPX compiled the Interim Report in January this year on measures to address issues such as Green Wash including market-based initiatives. The Interim Report states, if there is a framework that enables sharing of desirable specific criteria as to "green" or "transition" among market participants and authorities, and checking and certifying the eligibility of the ESG bonds, i.e., that they are issued based on such criteria, this would increase the transparency and objectivity of third party evaluations and leads investors and issuers to participate in the market with confidence.

The Interim Report states, on the other hand, that since the current state of the ESG investment market is still developing in and outside Japan, it would first aim to improve comparability and transparency by sharing transaction information on how and for what causes issuers and evaluation providers have determined their ESG eligibility on the JPX Information Platform, at the same time continuing to examine how it would be possible to develop a framework for objectively certifying eligibility of ESG bonds, etc.

For the content of green business, the MOE has compiled the "Green Bond and

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[38] Responsibilities and duties to be performed by those who manages the funds of others for the benefit of beneficiaries

Sustainability-Linked Bond Guidelines 2022", which aims to clarify the concept of greenness in order to ensure the credibility of green bonds, taking into account international trends.

With regard to transition in particular, as stated in the First Report, Japan formulated the "Basic Guidelines on Climate Transition Finance" in May 2021 to sort out the basic principles related to transition finance. In the following year, discussions on how to set interim targets have been accelerated internationally and in both the public and private sectors[39]. Therefore, it is essential to work towards establishing a perspective on target-settings. Companies and FIs, in cooperation with each other, either domestic or foreign, are required to steadily formulate and disclose their effective transition plans.

As mentioned above, the "GX League Basic Plan" announced in February this year, states that discussions will be advanced on making the league fully operational from 2023, as a place where companies that consider decarbonization as an opportunity for economic growth can work together with the government, academic, and FIs. The participating companies will formulate and announce their interim 2030 targets of reduction, consistent with 2050 carbon neutral. They will report the status of their efforts every year and assess the status of achievement at interim points. If they do not reach their targets, they will engage in voluntary credit transactions through carbon credit markets.

Regarding carbon credit markets, METI's study group published a report in June this year[40]. The report classifies and organizes J-Credit, JCM and other credits that contribute to national greenhouse gas reduction targets (NDCs), and other voluntary credits including those related to carbon absorption and removal. Based on this, the report clarifies the roles of each credit in national policies and states measures for future supply expansion. In addition, the report stipulates that since credit transactions are at present mainly conducted through bilateral transactions, there are problems such as the lack of clear price signals. Therefore, the METI plans to proceed with proof-of-concept demonstrations by exchanges from April 2022 with the aim of establishing market transactions in which prices are publicly announced.

As for international carbon credit market, exchange-based transaction infrastructures are actively under development in Europe, the United States, Singapore and other parts of the world, and therefore it is important for the relevant ministries and agencies to work together to study the ideal form of the market.

c) Impact

Sustainable finance is expected to contribute to the benefit of the entire economy and society, such as improving these issues through financing and investment that appropriately reflects externalities and takes environmental and social issues into account.

Regarding impact investment intended to create such environmental and social effects ("impacts"), the First Report points out that there are challenges in establishing procedures and methods for evaluating environmental and social effects. If many market participants recognize, the Report states, that the creation of impacts leads to the stability

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[39] METI announced the Asia Energy Transition Initiative (AETI) initiative, which aims to support the simultaneous achievement of sustainable economic growth and carbon neutrality in Asian countries, and is working to support the development of transition roadmaps. In addition, GFANZ launched the APAC Network in June this year to strengthen cooperation among stakeholders in Asia.

[40] METI Carbon Credit Report
https://www.meti.go.jp/press/2022/06/20220628003/20220628003.html

of corporate earnings and the improvement of corporate value, this would create a virtuous cycle of corporate disclosure and impact investment by investors.

The "Study Group on Impact Investment" held jointly by the FSA and the Domestic Advisory Committee of the Global Steering Group for Impact Investment (GSG), held six times of discussions since its launch in June 2019, whose essences were summarized in September 2021 as "Achievement of the First Phase and Future Issues"[41].

The summary states that a certain level of understanding was obtained among the participants in the Group on the basic contents of impact investment. Going forward, discussions, as the Second Phase of the Group, will be held to improve awareness of examples of positive correlation between impact creation and economic returns, and develop investment techniques according to asset types such as investment and lending, so as to attract diverse stakeholders to impact investment.

It is important for the public and private sectors to work together to build an ecosystem that realizes a virtuous cycle of impact investment, such as further materialization and dissemination of measurement methods. In addition, the Government's "Global Health Strategy" also stipulates that appropriate measurement and visualization of the expected impact of investment, particularly in the global health field, should be considered, and it is desirable to work in conjunction with these developments.

d) Technologies, SMEs, and climate-tech

In the area of climate change, among various ESG issues in particular, it is essential to develop and evaluate innovative technologies, including significant improvements in efficiency and energy conversion.

The development of new technologies entails uncertainty. If successfully developed and widely implemented, however, those developed technologies would possibly have huge environmental as well as economic impacts, given that there are still many areas where technologies to realize decarbonization are still under development.

For example, compared to R&D in which large corporations invest based on their own judgment and capital, in the case of start-up companies in fields such as climate change (hereinafter, climate-tech), it is important to obtain, at an early stage, an accurate assessment from outside parties of the potential of their science and technology. How to secure stable financing during the development period, or periods from early funding to stable profitability would be an issue for all start-ups. For climate-tech, the issue is particularly important as it is pointed out that it would usually take longer time to become profitable in the area.

From the financial side, if climate-tech can help measure environmental impacts beyond investment returns (for example, by visualizing the extent to which greenhouse gas emissions have been reduced as a result of the introduction of a certain technology), it may be possible to stimulate investment demand for technology-based start-up companies from FIs and investors interested in the growth of investee companies and the reduction of emissions.

In this regard, in order to further promote climate change-related impact assessments based on past initiatives, the MOE will work with practitioners to develop a framework for evaluating potential reductions in CO2 emissions by referring to precedent cases in other countries. It is important for the FSA to actively participate in this study and, taking

[41] https://impactinvestment.jp/news/research/20210929-2.html

this into account, consider creating an environment conducive to supporting the climate-tech companies[42].

As local SMEs support approximately 70% of Japan's employment and account for 10-20% of all greenhouse gas emissions in Japan, it is important for them to accelerate their efforts and realize innovation. Addressing climate change issues can also lead to cost reductions through energy conservation and stronger management capabilities through improved products and corporate competitiveness. Government support measures are also being implemented in a variety of ways.

For example, the MOE has established the subsidy for regional decarbonization transition and renewable energy promotion and is working to strengthen the support system of local environmental offices for local governments and companies, in order to continuously and comprehensively support local governments over several years in order to realize at least 100 leading decarbonized regions by FY 2030. It also is planning to establish a support organization for decabonization which would provide funds to local companies in various forms such as equity investments, mezzanine (subordinated loans, etc.), and debt guarantees, thereby expanding support for renewable energies and the effective use of resources.

The Small and Medium Enterprise Agency (SME Agency) is also compiling in various ways issues such as decarbonization that are easy for SMEs to address, industry-specific issues, and subsidy programs.

Although the Government and industry associations have already been promoting these measures, relevant ministries and agencies need to continue to disseminate those Government' efforts widely to regional companies and FIs.

e) Collection and publication of data

The importance of climate change data is increasing, as discussions on sustainability disclosure by companies in Japan and overseas are advancing, and it is becoming important to understand emissions including business partners (Scope3), for example, in FI's initiatives to achieve net-zero.

With regard to data published by companies, as mentioned above, it is expected that JPX will develop a data infrastructure with high user convenience (UX) in conjunction with the disclosure information system.

On the other hand, although various research institutions in Japan and overseas are already developing data on climate change and its impacts, such as changes in precipitation and temperature, it is important to obtain more accurately specific data on items and targets in order to grasp the specific impacts on individual regions and companies.

In this regard, the Ministry of Education, Culture, Sports, Science and Technology (MEXT), MOE, FSA, and other relevant ministries and agencies are working together to set up a forum for discussions involving private-sector practitioners as early as this fall, to identify climate change prediction data that are practically useful for FIs, investors, and companies, and to explore how to utilize those data. This may serve as a basis for financial and industrial practitioners to appropriately identify, and encourage measures to physical and transition risks.

[42] In 2020, the MOE compiled the "Basic Approach to Impact Finance," and in 2021, it developed a guide ("Impact Assessment Guide Starting with the Green") that summarizes certain concepts and methods of impact assessment based on international initiatives.

f) Developing skilled professionals and dialogues with diverse stakeholders

As stated above, there are a variety of measures necessary to promote sustainable finance, but the development and enhancement of human resources with specialized knowledge is an urgent issue throughout these measures.

The First Report points out the importance of developing human resources suited to each field and situation, for example, institutional investors who engage in dialogue with companies, securities companies and banks who are responsible for selling ESG products, asset managers who provide advice to customers, and ESG evaluation institutions who evaluate companies.

Currently, from the perspective of supporting ESG disclosure by companies, the JPX "ESG Knowledge Hub" provides information such as disclosure points of listed companies, disclosure examples, and introductions to ESG evaluation organizations. It is important to expand and appropriately link this Hub with the JPX *Information Platform* (see p20) and develop it as an information hub where parties involved in the broad financial field could acquire practical knowledge.

At present, some organizations relating to finance are considering setting up training and qualification examinations specialized in sustainability[43]. Universities are also offering various lectures aimed at solving social issues. It is important for the FSA, corporate groups, consortiums, and specialized institutions and experts with expertise in human resource development in the field of sustainability, to work together to visualize the knowledge and skills that are practically required to implement sustainability finance, together with those which can be acquired through the trainings (skill maps).

In particular, it has been pointed out that understanding of scientific knowledge, as well as those on humanities, is becoming increasingly important in the financial sector as decarbonization efforts are gaining more importance. It has also been pointed out that the acquisition of knowledge and skills should be encouraged for wider personnel including via so-called recurrent education. Considering these points, the FSA and other related parties should disseminate skill maps widely and actively support training and qualification examinations that should be expanded in light of the necessary knowledge and expertise described in the maps.

Furthermore, in order to increase the depth of human resources, efforts should be made to provide knowledge on sustainable finance to interested persons from before they participate in practical work, that is, from their school years. Such efforts may lead to the development of future financial practitioners, as well as increase the interest of a wide range of individuals and deepen their understanding of aspects such as contributing to society through capital markets, which may expand the market in various ways.

Specifically, in cooperation with finance-related industry associations, one way would be to provide classes or teaching materials on sustainable finance in finance-related courses at universities and graduate schools, or to distribute more basic teaching materials in SDGs-related classes at high schools.

The FSA has prepared teaching materials in response to the expansion of financial and economic education in the revision of the High School Curriculum Guidelines that started in April this year. With these materials, meanings for ESG-investment or ways to support

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[43] For example, the Japan Securities Dealers Association (JSDA) has added content related to sustainable finance to the scope of the Qualification Examination for Sales Representatives since July 2022.

SDGs through consumption or investment could further be disseminated to the youth[44].

Furthermore, it is important to approach and listen to the opinions of, and to advance dialogue with, a wide range of stakeholders, including young people and citizens, not just practitioners and students.

Sustainability issues have cross-generational and cross-geographical impacts, such as the choice of past generations affecting future generations, or the activities in a particular country having the global impacts.

For this reason, each stakeholder may have a variety of perspectives depending on the nature and degree of impact from environmental and social issues. By engaging in dialogue with various stakeholders, it is possible to gain important perspectives and new insights that are essential for promoting measures. One way could be, for instance, to invite young people who are working on various sustainability issues to engage in dialogues with the Expert Panel.

[44] For example, JBA is developing educational materials on sustainable finance for high school students, which could be linked to such initiatives (https://www.zenginkyo.or.jp/education/material/)

(6) Follow-up and external communication

As described above, there are various issues and measures related to sustainable finance, including enhancing corporate disclosure, capital market functions, the role of FIs, as well as overreaching agendas, and the related ministries and agencies are not a few.

The FSA should properly implement each measure under government-wide policies and plans, such as the "Grand Design and Action Plan for New Capitalism", in close cooperation with relevant ministries and agencies.

Based on close cooperation with relevant ministries and agencies, the Expert Panel will continuously follow up on the implementation status and overall picture of sustainable finance measures, and update and disseminate it as needed.

In particular, with regard to discussions on FIs, there are a variety of related measures, and it is conceivable that ongoing discussions will be held on the situation from time to time and further responses.

As stated in the "Grand Design and Action Plan for the New Capitalism" and the "Clean Energy Growth Strategy (Interim Report)", the entire Government of Japan will proceed efforts such as promoting the expansion of the industry areas for roadmap for net-zero, and formulating quantitative models that quantify emission pathways, and developing a framework to promote energy conversion. It is important for the relevant ministries and agencies including the FSA to cooperate in discussions so that FIs can take effective actions considering environmental and industrial policies.

In addition, it is expected for the FSA to promptly update the overall picture and implementation status of the measures that the Expert Panel is following, taking into account the remarkable changes in the environment surrounding sustainable finance. This may include updating the picture and timetable described on page 2, 3 on the FSA website in a timely manner.

Furthermore, it is desirable to update in a timely way and disseminate in an integrated manner, in cooperation with relevant ministries and agencies, the overall pictures and roadmaps of the Government's sustainable finance policies[45], which would in turn lead to enhancing the understandings for Japan's policies in the international community, including in Asia.

As Japan will be hosting the G7 next year, the FSA needs to contribute to international discussions including by communicating the essence and necessity of effective transitions, taking advantage of accumulated discussions at the G20 and G7 meetings so far.

[45] For example, in the EU, the European Commission formulated the Sustainable Finance Action Plan in March 2018, which is promoting policies while presenting the overall picture for multiple years.