Report by the Working Group on Impact Investment

- Toward Growth and Sustainability through Addressing Social and Environmental Issues -

June 30, 2023

Description

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(As of June, 2023)

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1. Introduction

Building a sustainable society has become a major international challenge. The same as in Japan, the importance of social and environmental issues such as decarbonization, declining birthrate, aging population, and coping with disasters is rapidly increasing. Innovation, which includes the implementation of new technologies and business model reforms that contribute to solving these issues are indispensable. Therefore, supporting companies working on such implementation and reforms is an urgent task.

ESG investment [1] is an investment approach that takes into account social or environmental issues in its investment decisions.[2] By this way, it strengthens the foundations of, or reduces the risk relating to, economic and financial activities and consequently enhances the sustainability of the whole economy. The amount of ESG investment is expanding globally; the balance of global ESG investments in 2020 is approximately 3,700 trillion JPY (US$35 trillion), while the balance in Japan is approximately 310 trillion JPY.[3] This is a 1.5-fold and 5.8-fold increase from 2016, respectively. Their shares in total investments are also significant, at about 36% globally and 24% in Japan.[4]

So-called "ESG integration" and "screening," which account for nearly 90% of ESG investments, are investment methods that reflect ESG factors in investment decisions, mainly by comprehensively evaluating a company's ESG efforts and determining the investment ratio accordingly, or by excluding companies from the investment portfolio based on the characteristics of the company or its industry. Although all of these approaches have contributed to the expansion of ESG investments, these would not be likely to confirm to what extent individual investments actually lead to the implementation of specific technologies or changes in business models that contribute to resolving social or environmental issues, either domestic or international.

"Impact investment," one of the investment methods of sustainable finance,[5] is gaining momentum in Japan and abroad as a method that focuses on the "impact" of investments while sharing with other methods of sustainable finance the fundamental role of building sustainable social and economic foundations. As an investment method that identifies

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[1] Although there is no clear definition of ESG investment, the Global Sustainable Investment Alliance (GSIA) defines ESG integration, negative/positive screening, impact investing and others as "sustainable investment" as a relevant statistic. This is referred to as "ESG investment" in this document.

[2] In this report, financial transactions such as investments (stocks and bonds), loans, and investments in infrastructure and other real assets are collectively referred to as "investments". Fund-providers of those investments are referred to as "investors," or "investors or financial institutions," which in either case includes not only fund providers to stocks or bonds, but also commercial banks that provide lending.

[3] 1 USD = 107 JPY (as of the end of March 2020)

[4] Survey by GSIA (The Global Sustainable Investment Alliance) and JSIF (Japan Sustainable Investment Forum) (2020)

[5] "Sustainable finance is not just a specific financial product, but it refers to the comprehensive picture comprised of the financial system or mechanism, code of conduct, and evaluation methods that supports a sustainable society" (Report by the Expert Panel on Sustainable Finance, Financial Services Agency, June 2021)
https://www.fsa.go.jp/news/r2/singi/20210618-2/04.pdf

technologies and services contributing to solving social or environmental issues, as well as companies and businesses that provide such technologies and services, impact investment would focus and realize the potential of diverse companies, regardless of their sizes or growth stages. It would also have high affinity for supporting start-ups that specialize in specific businesses and seek future business growth. Investors and corporates see potential in the investment's creating innovations that lead to solve social issues.

The Working Group on Impact Investment (hereinafter referred to as the Working Group) was established under the Expert Panel on Sustainable Finance of the Financial Services Agency, Japan (JFSA), in order to discuss expectations for impact investment and measures to expand it. This report summarizes the discussions in the Working Group.

Since its establishment in October 2022, the Working Group has engaged in wide-ranging discussions on a total of eight occasions with the participation of investors, financial institutions, and businesses in Japan and overseas. From next section, the report summarizes the overview of impact investment and present a draft of the "Basic Guidelines on Impact Investment" in section 3 from the perspective of fostering a common understanding among stakeholders on the basic role, concepts, and key elements of impact investment.

In light of the fact that impact investment markets are in their early stages and that market practices are evolving, the Working Group will actively disseminate the contents of this report to a wide range of market participants in Japan and overseas, and to finalize the Basic Guidelines considering a wide range of inputs and opinions. The Working Group believes the draft Basic Guidelines should be finalized through wide-ranging dialogue and engagement with relevant stakeholders, as well as promotion on the report, including policy measures illustrated in section 4. Through these processes, the Working Group hope that there would be more widespread understanding among various stakeholders, such as investors, financial institutions, enterprises, international organizations, and local communities, on the existence and role of businesses that tackle social or environmental issues and achieve growth. These processes would also enhance finance that contributes to these businesses.

(1) Role of Investment in Companies that Realize Social or Environmental Impact

With the growing importance of social and environmental issues, an increasing number of enterprises are perceiving that realizing "impact" in their businesses, or advancing solutions to social or environmental issues, is inseparable from enhancing future values of their business. On this basis, more entrepreneurs are introducing new technologies and reforming their business models to innovate the new businesses.

New technologies are essential for addressing a wide variety of social and environmental issues. Once implemented, they may appeal to companies and other stakeholders seeking to solve the issues and lead to rapid market expansion.

However, businesses alleviating social or environmental issues have various pathways and time horizons to fulfill their business potential, and it is sometimes not easy to gain general understanding about the outlook for financial returns the business would deliver. For example, in the case of developing innovative technologies that contribute to solving problems and launching a business, it is important to obtain accurate assessments of the forecast of the technologies and products from sponsors and investors at the initial stage of the business. There are uncertainties, however, in the deployment of new technologies and the transformation of business models. In the case of companies engaged in drug discovery, for another example, it would be necessary for newly developed drugs to undergo a long-term process before they become profitable, such as basic research, clinical research and trials, approval by the authorities, and practical application. It would also take time for doctors or patients to recognize the new drugs. Even if there is a high level of technology that contributes to social impact and growth potential, it would often takes time to generate returns.

In addition, there may be cases where a company's existing products, services, technologies, etc., have increased potential in response to changes in social and environmental issues, but are not fully recognized as such and do not result in business creation or innovation.

In Japan in particular, critics observe that it is sometimes difficult for companies and businesses which have social or environmental impacts but need a longer period of time to achieve financial return, to gain an understanding on their business potential and to receive financial and business supports. For example, the amount of investment in start-ups that are working to solve climate change was USD 60 billion worldwide in the first half of 2021, of which approximately 65% was transacted in the United States[6]. Many research argue that there would be much room to expand investment in Japanese startups, via venture capital, funds, and other finances.[7]

In particular, commercialization of so-called deep tech[8] generally requires long-term, large-scale Research and Development (R&D) expenses and major capital investment for scale expansion. However, technical expertise, long time-horizons, and uncertainty for financers to understand and establish businesses with those technologies could evidently make deep tech entrepreneurs difficult to secure long-term funds to expand their businesses.[9]

On the other hand, according to a survey conducted in 2021, more than 70% of start-ups in Japan answered that their motives for founding businesses were "to resolve societal issues or to contribute to society,"[10] indicating that there is a significant increase in the number of entrepreneurs in rising generation in particular who consider solving social and environmental issues as the axis when considering launching businesses.

Under the "New Form of Capitalism,"[11] the Government of Japan advocates that addressing social or environmental issues would be an energy for growth for its society

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[6] PwC, " State of Climate Tech 2021", with Europe at 21% and China at 10%

[7] VC investment as a percentage of GDP in 2020 was 0.79% in the U.S. and 0.04% in Japan (Source: Material of administration office in the Working Group on Capital Market Regulations of the Financial System Council, October 2022).

[8] Technology based on scientific discoveries obtained through research in specific natural sciences which has the potential to have an impact on society, such as solving economic and social issues that should be solved by the country or the world as a whole if the technology is commercialized and implemented in society (The Ministry of Economy, Trade and Industry (METI), "Deep Tech Startup Support Business" (February 2023)).

[9] METI, "Building an Ecosystem for Deep-tech Startups" (February 2023)

[10] Survey by Venture Enterprise Center " VEC YEARBOOK 2021", "Startup Development Five-year Plan " (November 2022)

[11] Japanese Government advocates new forms of capitalism as a major transition in a form of capitalism whose core concepts include a virtuous cycle of growth and distribution.

known for unique set of challenges, and has proposed various policies including promoting impact investment.[12] It also has played a certain role for international discussions on impact investment, as seen by the proposal and approval at the G7 Hiroshima Summit in May 2023 of an initiative to promote impact investment in Global Health.[13]

Various investors' and financial institutions' supports to a start-up, large enterprise or regional company that seeks to resolve social or environmental issues and grow its businesses, financial and other supports that are necessary and appropriate in line with the characteristics and growth stage of each business would significantly be important for enhancing the prospects and sustainability of the company and the economy.

(2) Common ESG Investment Approaches

There is a wide range of investment strategies and methods that link social and environmental issues with investment actions.

For example, Socially Responsible Investment (SRI) has been observed since the 1920s in the United States. Initially, most of the SRI was conducted through so-called "negative screening," in which certain industries and companies were excluded from investment portfolios. In the 1970s, however, there was a spread of shareholder action, in which shareholders encouraged the resolution of social or environmental issues, as well as community investment, in which the poor and minorities in local communities were encouraged to become economically self-sufficient. Then in the 1990s, there was a spread of "positive screening," in which investors pursue high-returns by selecting companies that are relatively advanced in fields such as the environment.

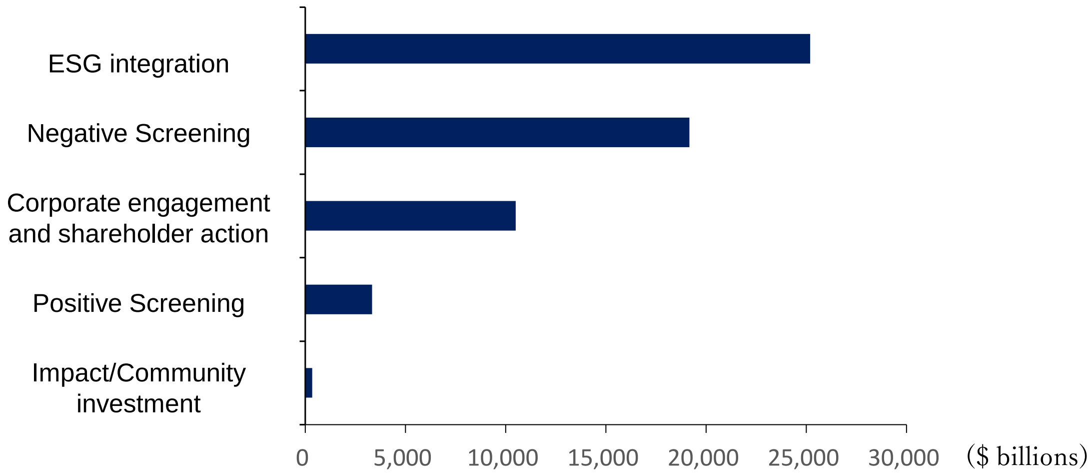
From the beginning of the 2000s, the recognition that responses to social and environmental issues are indispensable for improving the sustainability of companies and businesses gradually spread in corporate management. Investors and financial institutions have moved forward with management and investment strategies that consider sustainability in terms of environmental (E), social (S), and governance (G) issues that would secure long-term corporate and investment values.

The statistics of ESG investment by investment strategy provided by the Global Sustainable Investment Association (GSIA) shows the most popular investment strategy would be ESG integration, where investment managers systematically and explicitly incorporate environmental, social, and governance factors into their financial analysis, followed by negative / exclusionary screening, and exercise of shareholder action and corporate engagement.

[12] "Basic Policy on Economic and Fiscal Management and Reform 2023", "Grand Design and Action Plan for a New Form of Capitalism 2023 revision" (June 2023), "Startup Development Five-year Plan" (November 2022)

[13] The G7 Hiroshima Leaders' Communiqué emphasized the importance of sustainable finance in global health, including through impact investments and endorsed the establishment of the Impact Investments Initiative (Triple I) for Global Health, an initiative to raise awareness and share best practices in impact investing.

(Figure 1) Balance of ESG investment by investment strategy



Source: JFSA, based on data from Global Sustainable Investment Review 2020 (GSIA)

ESG integration and negative screening have contributed to the expansion of ESG investment as they have been implemented through various creative efforts. They are now widely implemented by asset owners and asset managers in Japan and the world-wide.

In long-term corporate management, various ESG factors, such as compliance with regulations, consideration for labor and human rights, proactive efforts for the environment, and consideration for diversity, are the foundations of business, and they may manifest as risks in some cases. Comprehensive evaluation of companies' ESG efforts through ESG investment have significant roles in encouraging dialogue between companies, investors, and financial institutions, on companies' broad strategies and actions to respond to the risks and to improve the sustainability of their businesses.

(3) Role of Impact Investment

Along with the spread of ESG investment methods, which encourage social or environmental improvement by selecting in investment decisions companies or groups of companies that are socially or environmentally sound, there is a growing need to more individually and clearly grasp and consider the specific impacts each investment has on individual investee company and business.

When formulating investment decisions based on ESG evaluation, as typical in investment practice seen in ESG integration, investors generally integrate overall evaluations on companies' ESG efforts into their financial analysis, and then select investment targets or ratios in accordance with the ESG evaluations. In the case of screening either, both in "negative screening" that focuses on “negative” elements of a company's industry, business, governance and decides not to invest in companies with particular problems, and "positive screening" that evaluates a company's ESG efforts and select investee companies or group of companies, do not necessarily take into account the effects individual investments have onto each investee company or business.

Yet, for example, certain companies may possibly have difficulty attracting financial resources in those investments, such as;

- a company that belongs to a high-emitting industry and currently emits a larger amount of GHGs than other companies or industries, but has a clear strategy and technologies to reduce emissions, and is making capital investments accordingly, or
- a start-up that has the great potential to significantly reduce emissions from other companies' manufacturing processes with their proprietary technologies but is currently focusing on R&D, has no particular business revenues, and is still in the process of developing their governance structure.

In other words, even with great potential, in an ESG evaluation that comprehensively assesses ESG factors, or in ESG indices based on ESG evaluation, those companies above may not be likely to obtain a sufficient evaluation given their current emissions are higher, or they have poor track records of emission reduction (E), nor do they appear to take special efforts to ensure diversity, working conditions (S), or governance (G), compared to other companies.

As social and environmental issues diversify, such as the transition to net-zero, the conservation of biodiversity, responses to marine plastics waste, the expansion of diversity, and aging society with fewer population, an investment method that specifically focuses on each ESG issue and understands and evaluates the growth potentials of a company or business that are not fully captured by conventional ESG investment methods is becoming increasingly important.

"Impact investment" has core characteristics of proactively identifying specific social or environmental "impact" that should be realized through an individual investment, and committing to strategies to actually realize those "impact," as well as generating a certain level of "financial return" as in the same manner as regular investments.[14]

By specifying the "impact" and "financial returns" to be realized through investment, impact investment would clarify the accountability of investors, financial institutions, and companies, improve the ability of investors to discern specific technologies and measures to realize the "impact" and "financial return," and improve the effectiveness of engagement and dialogue between investors and investees.

Assessing the certainty of companies' future impact[15] beyond their current ESG efforts would likely to be compatible with fostering the development of start-ups, large enterprises or regional companies that challenge future market creation through the impact, regardless of their sizes or growth stages. In particular, impact investment in new businesses is highly desired to evaluate the social or environmental impact and growth potential of the businesses and encourage their problem-solving and entrepreneurial innovation.

The JFSA's Expert Panel on Sustainable Finance have been discussing the promotion of sustainable finance in Japan and abroad, with an understanding that the finance that take

[14] This report discusses the "social or environmental impact" and "financial return" realized through investment. The former refers to "social or environmental impact," "improvement effects," or "impact," while the latter refers to "return," "financial return," "profit," "profitability," or "business potential," etc.

[15] Identifying the strategies and causal pathways that realize the social or environmental impact through the investment, and verify the certainty of realizing the impact. In general, such strategies and causal pathways are called "logic models" or "Theory of Change" by practitioners in Japan and overseas, and would often invite explaining in detail processes and mechanisms through which investment produces impact or changes in societies or environments.

social and environmental issues into account would reduce the risks and strengthen the foundations of economic and financial activities, and therefore enhance the sustainability of the entire economy.

Equally, as impact investment aims to create specific social or environmental impact and financial returns, its promotion will in general contribute to solve social or environmental issues and improve business performance, incorporating externalities into financial markets and strengthening and improving the sustainability of the entire societies. In this regard, it would be fair to consider that impact invest plays essential roles as one of the fields of sustainable finance.

(4) Main Scope of the Working Group

Some critics state that impact investment in effect originated from a proposal made by the Rockefeller Foundation in 2007. The Foundation advocated impact investment by arguing for integrating philanthropy and investments, by moving beyond then-traditional concepts that the former emphasizes social or environmental improvement effects primarily, and the latter financial returns mainly.

In 2013, at the proposal of U.K. G8 Presidency at the time, the G8 Social Impact Investment Task Force was established, consisting of private investors, research institutions, etc. In 2015, this Task Force evolved into an international committee (GSG: Global Steering Group for Impact Investment), and has been promoting various activities such as dissemination, acknowledgement, and know-how sharing worldwide.

In 2017, the Government of France launched a forum of French companies, financial institutions, and relevant ministries and agencies and the forum presented impact investment as "an investment or financing strategy that aims to accelerate the just and sustainable transformation of the real economy.”[16]

The Working Group carefully discussed and examined the relationship between investments’ social/environmental impact and financial return, comments presented in the Group include, but are not limited;

- When companies try to solve social or environmental issues with conventional business models and ideas, the businesses normally incur costs in terms of both time and money, therefore, addressing the issues and achieving returns are often considered at first glance as “trade-off.”
- However, as interests grow in social and environmental issues and their effects on businesses, "impact investment" may expand new forms of investment supporting innovation that would address social or environmental issues as well as gains in profitability.
- Rather, through various ingenuity, tackling social or environmental issues can become compatible with realizing returns, or they could induce synergistic effects respectively. In particular, as more and more companies recently aim for their business growth by solving social or environmental issues, investment capturing such movements will be important going forward.

Grounded in the discussion at the Working Group, this report considers impact investment certainly as an "investment,” which aims at a defined level of financial return, besides having social or environmental impact. Specifically, based on the understanding

[16] See Reference 1 for the summary of these foreign initiatives.

that social or environmental impact and business potentials would presumably complement and strengthen one another and become mutually compatible (positive feedback loop) through various ingenuity and creativity, and that investment realizing this positive feedback loop would be indispensable for the global and Japanese society and economy, this report proposes that “impact investment” is an investment that intend to realize social or environmental impact and business potential through investment.

While acknowledging that the level or balance of social or environmental impact and financial return required vary depending on the type of investors and investees, this report in principle does neither cover funds or investments for which financial return is not expected from the beginning (such as donations), nor investments whose intended impact is not clarified.

There are various social or environmental impact that can be realized through investment. For example, in some regional economies, amid the rapidly aging of society with low birth rate, revitalizing business success itself would be an urgent social issue.

Even in this case, clarifying in advance investors’ intention to achieve "impact" and "financial return" through innovation and ingenuity would be necessary for the investment to proclaim to be an "impact investment;" after all, retroactively recognizing social or environmental impact after the execution of investment would not basically be the purpose of this report. In principle, all investments and businesses have some extent of social or environmental impact, but those that satisfy the four principles shown in the Basic Guidelines are listed as "impact investment" in this report.

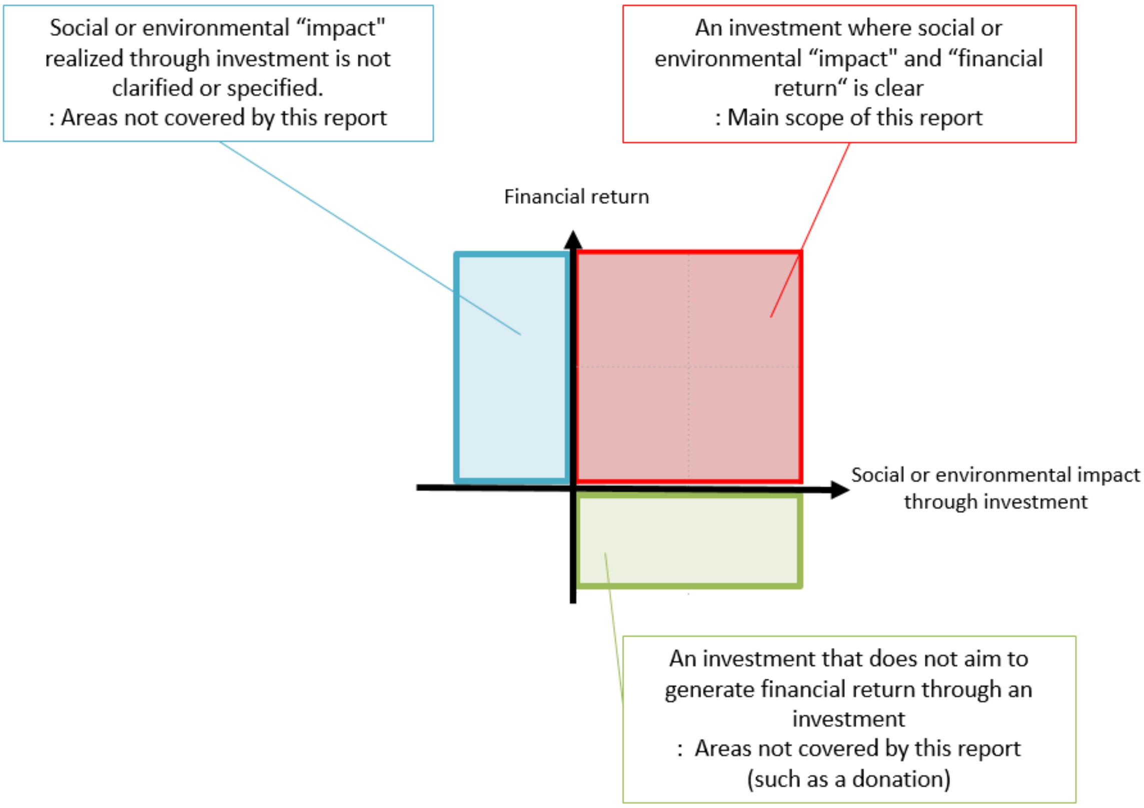
Figure 2 illustrates the concept of impact investment in this report. The horizontal axis is the "social or environmental impact" of investment and the vertical axis is the "financial return" on investment. The financial return on investment should be considered individually for each investor and financial institution, including consideration for its fiduciary responsibility, however, investments that in total categorically fall below the scope of these fiduciary responsibilities are considered to be classified as donations in this figure.[17]

The horizontal axis of the figure, assuming that all investment and investees’ businesses have some form of "impact" on society and the environment, takes into account impact that are specifically intended and specified to be realized through investment.

As described in 2. (1), most of the global impact investments that are currently being made are aimed at obtaining financial returns equal to or higher than those of other investments.

[17] See footnote 53 for an international discussion of the relationship between investment returns, addressing social or environmental issues, and fiduciary responsibility.

(Figure 2) Concept of social or environmental "impact" and "financial returns" realized through investment



As will be described later, the proposed Basic Guidelines broadly cover wide ranges of impact and financial returns realized through investment, as well as various time frames to realize the impacts and returns. Namely, the proposed Basic Guidelines do not limit the type of investees, investors, and asset classes of investment, based on the understanding that the basic concepts of investment that realizes both social or environmental impact and financial returns are fundamentally common, taking into account international discussions.

Given the increasing importance of social and environmental issues, there is an urgent need to ensure that solving these issues would lead to the growth of businesses and the sustainability of social and economic foundations, and in this context, companies attempting technological development and business model innovation are much anticipated to play leading roles. As for start-ups, as they have generally simple structures in terms of business operations, finance structures, and future business goals, gauging the social and business “impact” of investment to those start-ups could be relatively easier than to large, complex companies.

Thus, nevertheless the key principles for impact investment presented in this report or draft Basic Guidelines do not limit their scope on investment targets and investors, as a policy priority, the report notifies that impact investment could be particularly compatible to promote start-ups that realize social or environmental impact and business growth through their new ideas and creativity. For example, specific cases referred in Reference 4 below are stating from investments to start-ups, and policy measures proposed in Section 4 are sometimes implies those to start-ups.

At the same time, the report also notifies that realizing "impact" and enhancing corporate values in the listed market should also be essential parts of impact investments, as these would provide wider implications and impacts on the society as a whole, including to unlisted companies and that efforts in the listed market are also necessary and expected, as described in Section 4.

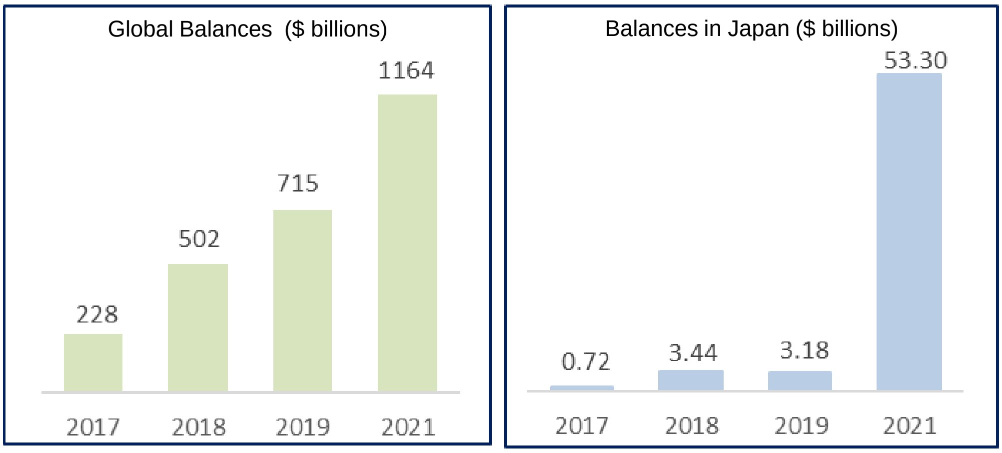
2. Domestic and Overseas Trends in Impact Investment

(1) Overview of Domestic and Overseas Markets

Although there is a range of definition of impact investment, various surveys have confirmed an increasing trend of impact investment. The global balance of private-sector fund investment is said to be approximately 300 billion USD[18] to 1 trillion USD[19].

Japan's market size in 2021 is estimated to be around 5 trillion JPY at the largest, which is smaller than that of global markets.[20] According to a survey of Japanese institutional investors and financial institutions, 70% of respondents said that the impact market in Japan is "in the stage of future growth," indicating the possibility of growth compared to other countries.

(Figure 3) Impact investment market size in the world and Japan



Source: Global Impact Investing Network (GIIN)

Source : The Japan National Advisory Board, The Global Steering Group for Impact Investment (GSG-NAB Japan)

GIIN and GSG-NAB Japan aggregated the figure above based on the answers to questionnaires from institutional investors and financial institutions

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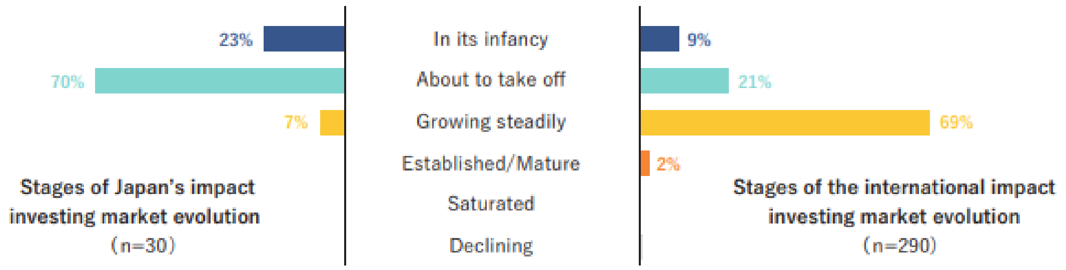
18 The Global Sustainable Investment Alliance (GSIA) (2020)

19 Global Impact Investing Network (GIIN) (2021)

20 The Japan National Advisory Board, The Global Steering Group for Impact Investment (GSG-NAB Japan) (2021)

(Figure 4) Impact Investment in Japan

(Response to the question "How do you recognize the current situation of the impact investment market? Please select the most appropriate one.")



Source: Created based on the Questionnaire Survey regarding Impact Investment (2021) (GSG National Advisory Board) and the GIIN Annual Impact Investor Survey 2020. - Question: "D5. How do you see the state of Japan's impact investing market? Please select the answer that most accurately describes your view. (Single Answer, hereafter "SA")"

Source : GSG-NAB Japan "The Current State and Challenges of Impact Investing in Japan (FY2021 Survey)"

According to a survey by an international organization,[21] the asset allocation of impact investment to East Asia, including Japan, is 21%. On the other hand, the headquarters of the fund providers are located; 45% in North America, 26% in Europe, and 4% in East Asia. Thus, it is pointed out that there is room to expand the base of investors and financial institutions in East Asia including Japan.

As for the financial return, two-thirds of investors and financial institutions that engage in impact investment set a target rate of return that is equivalent to or higher than the market rate of return for other investments. An analysis of the actual rate of return shows that the rate of return achieved by impact investment in the private market is not much different from the overall rate of return.[22]

Looking at investment record by life stage of investees, in Japan, less investment has been made to companies in seed-stage and growth-stage[23] than overseas, while more investment has been made to companies in later-stage (listed companies that have achieved sufficient profits and scale). Regarding industries, there are much investments in environmental fields such as energy and forests in global, in Japan, on the other hand, there are more investments in social fields such as health and medical care as well as women's empowerment.[24]

Interest in impact investment is growing also in Japan. In June 2020, "Impact Investing Roundtable," co-hosted by the Japan National Advisory Board, the Global Steering Group for Impact Investment (GSG-NAB Japan) and the JFSA, was established to discuss practical issues in both equity and debt (loans and bonds) markets. In April 2023, the draft version of Impact Measurement and Management Guidance on Debt Financing was

[21] Global Impact Investing Network (GIIN) (2020)

[22] World Economic Forum (2013)

[23] The seed stage is considered to be " only the beginning, e.g., just an idea " and the growth stage is considered to be in the "generating revenues" stage (GSG-NAB Japan, The Current State and Challenges of Impact Investing in Japan, FY2021 survey (March 2022)).

[24] GSG-NAB Japan, "Current State and Challenges of Impact Investing in Japan, FY 2021 Survey" (March 2022)

publicized by the Roundtable to summarize practical issues in conducting impact investment through debt financing. In November 2021, "Japan Impact-driven Financing Initiative" was adopted by Japanese private investors and financial institutions to voluntarily declare their aims to realize impact through their business management.

On the industry or corporate side, the "Impact Startup Association" was established in November 2022 with the goal of "aiming to realize a sustainable society by understanding the resolution of social issues as engine of growth," disseminating information and co-creating value for the growth and expansion of impact start-ups.[25][26]

In addition, as technology progresses, young enterprises find themselves more places in local economies and communities, and there would likely to be numbers of local entrepreneurs striving to realize both social or environmental impact and business profits. This includes those who have profit targets that greatly differ from so-called unicorn[27] companies.

(2) Trends in Japan and Overseas Related to Impact Investment and Impact Assessment

(i) Green finance and other area-specific ESG investments

There are financial products and investment methods that identify and label areas of funding, such as green, climate transition and social finances. Guidelines for issuing bonds and other instruments with such labels have been developed in Japan and overseas.

For example, several guidelines for green sector state that the use of proceeds raised with the green label need "to obtain a clear environmental improvement effects," and provide a list of the use of proceeds subject to the green label. As for the transition, the use of proceeds is wide-ranging and the reliability and progress of the fund raiser's transition strategy is essential to bear the label.

Impact investment is an investment that aims to realize both "social or environmental impact" and "financial return," characterized by concretely identifying an investee and committing impact to be created by the investment. It is a cross-sectoral investment approach that is not limited to specific industries or ESG areas, therefore, the use of proceeds may overlap with existing ESG labels in each field.

For example, in the case of green bonds, a variety of projects are listed as having "clear environmental improvement effects," such as wind power generation, zero-carbon housing,[28] energy conservation with smart grids, wetland conservation projects, etc. Fund receivers or providers for green bonds are generally required to clarify the environmental improvement effects that should materialize by the bonds' proceeds.

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25 Defined by the Impact Startup Association as "start-ups that solve social issues and maximize their value impact on society through' impact' as a starting point"

26 The "impact economy" refers not only to the consideration of impact in investment, but also to an economy in which impact are implemented, including on the corporate side.

27 A company called "unicorn" is generally defined as a privately held company with a valuation of over US$1 billion that has been in business for less than 10 years. In this comparison, start-ups that seek to balance growth with social and environmental sustainability are sometimes referred to as "zebra" companies.

28 ZEH: Net Zero Energy House. A house that balances the energy used at home with the energy created by solar power generation and other renewable energy to reduce annual energy consumption to virtually zero or less

Impact investments would increase the effectiveness of realizing those impact by specifically committing to both environmental impact and the business potential.

In any case, the labeling of individual financial instruments is basically based on the ingenuity of investors and companies, and should be implemented in accordance with the respective principles and guidelines[29] according to the label. That being said, when the principles for impact investment are satisfied, it can also be called impact investment.[30]

(ii) Fund Name and Disclosure Regulations

In the United States, Europe, and other countries, in order to address so-called "washing"[31] and to ensure the reliability and transparency of ESG investment, there is a movement to prevent from setting investment funds pretending as "ESG funds" and to implement regulation on the requirements for the use of ESG labels including "impact" for financial products.[32]

Specifically, in Europe, the United Kingdom and the United States, when establishing and selling investment funds (such as investment trusts) called "impact" or "ESG," the new regulation requires to clarify from what perspective investment assets are "impact" or "ESG," and explain and disclose it to customers and other stakeholders.

In Japan, the JFSA revised "Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc." in March 2023 to ensure market integrity in ESG investment trusts. The revised Supervisory Guidelines state that in order for an investment trust to be labeled as "ESG," ESG should be a major factor in the selection of investment targets, and for publicly offered investment trusts, the content of ESG should be clarified in the prospectus. Then the Guidelines stipulate that in those cases, the funds' specific content of ESG and the criteria and indicators for the investment process should be disclosed.

These regulations are introduced for investor protection, market discipline, or sound market development purposes and for these reasons impose disclosure or asset composition requirement for financial instruments using a certain label, but do not prescribe the detailed contents of the ESG investment under each label.

On the other hand, guidelines on green investments mentioned above or the "Basic Guidelines" on impact investment described in section 3 are developed for the sake of promoting investment and therefore different in their nature from the regulations. Those guidelines provide the basic concepts and necessary elements of such investments in order to create a common understanding among market players.

By selecting investment products that are in line with green guidelines or the "Basic Guidelines," fund managers may sometimes meet the above regulations for investment funds consequently. Aligning with the Guidelines are, however, not always necessary to

29 E.g., The International Capital Market Association (ICMA): Green Bond Principles, Social Bond Principles, Sustainability Bond Guidelines; The Ministry of the Environment: Green Bond Guidelines; The Financial Services Agency: Social Bond Guidelines; The Financial Services Agency, the Ministry of Economy, Trade and Industry and the Ministry of the Environment: Basic Guidelines on Climate Transition Finance

30 See Reference 2 for widely spread ESG investment methods such as "integration" and an overview of ESG labels.

31 Pretending to have social or environmental impact even if the impact are not generated actually

32 See Reference 3 for the summary of Fund Name's Rule and Disclosure Regulations in Europe and the U.S.

complying with the regulations, nor are they developed for the sake of meeting the regulations.

(iii) Efforts to Incorporate Impact in Corporate Accounting and Disclosures

Although not always directly-connected to investment methods, there are also efforts to visualize "impact" and convert a company's impact on society and environment into monetary values, and provide these values along with its financial statements.

For example, "the Impact Weighted Accounting Initiative (IWAI)" of the Harvard Business School (HBS) in the United States and the Impact Task Force, a private organization in the United Kingdom, have discussed this issue. Some Japanese companies are trying to implement the IWAI methodology.[33]

In impact-weighted accounting (IWA), various impact of corporate activities, those on global environments, the corporate's employees, local communities and other stakeholders would be measured and converted into monetary values, which would then be added to ordinary financial statements such as sales and profits. Experts expect that developing IWA would deepen the understanding of social value created by the company, by comparing and examining over-time changes in both its impact-based monetary values and basic financial indicators such as net income.

On the other hand, critics observe the challenges in the implementation of IWA. The social or environmental impact of a corporation, for instance, tends to be idiosyncratic and difficult to compare with other corporations. Converting impact into monetary values by consistent methodologies would require careful examination. Also, comparing impact-based monetary values with ordinary financial indicators could pose questions on how, or whether or not, could these two indicators be compared effectively.[34] Therefore, further studies and trials on various assumptions, calculation methods, and usage are desirable.

3. Draft Basic Guidelines on Impact Investment

(1) Purpose of the Basic Guidelines

Impact investment is an investment that intends to realize both "social or environmental impact" and "financial return." In addition to generating a certain level of financial returns as "investment," it is characterized by identifying specific social or environmental impact that should be realized through an individual investment, as well as strategies and causal pathways to realize the impact. As one of the areas of ESG investment, impact investment is gaining popularity as a methodology that would encourage market creations or innovation by start-ups, large enterprises, or regional companies. At present, however, impact investment record in Japan and overseas is still in developing stages, and practices are in the process of trial and expansion.

The purpose of these Guidelines is to foster common understandings on basic concepts and processes for impact investment, by clarifying the essential elements expected for impact investment that fund-raisers, fund-providers, and other participants in impact investment markets could refer to when structuring and financing investment projects through their own ingenuities and approaches. The Guidelines are expected to encourage

[33] In collaboration with HBS, companies such as Acciona (Spain) and Eisai (Japan) have published practical initiatives on impact-weighted accounting.

[34] Financial Research Center (FSA Institute) Discussion Paper, " The Current Situation and Outlook for Impact-Weighted Accounts " (June 2023)

investment practices and dialogue among investors, financial institutions and companies, which may consequently further enrich their experiences and expertise.

In addition, as in the case of green or social finance guidelines, these Guidelines of impact investments could be utilized or referred to, as necessary, when external organizations or internal divisions evaluate or develop opinions on the consistency of an impact investment with the Guidelines.

Although "impact investment" differs from the investment methods such as "integration" and "screening" that are currently more common in ESG investment, it shares the objective of enhancing the growth and sustainability of businesses by addressing social and environmental issues. Therefore, promoting impact investment widely as one of the areas of sustainable finance could carry profound implications, as it may contribute to solving social or environmental issues and improving business viability through investment, then strengthening the foundation and sustainability of our societies and economies.

As investment practices have yet to be fully developed, key elements presented in this draft Basic Guidelines need to be formulated through dialogues with market participants, and the Guidelines need to be flexible and subject to further improvement and expansion as market develops.

Public consultation and dialogue toward finalizing the Guidelines and developing policy steps forward, including those on basic directions or concepts are essential. The Working Group welcomes and anticipates various opinions through these consultation and dialogue with wide range of stakeholders including investors and organizations who have started to or promoted impact investment in Japan and overseas.

In addition, as technology is rapidly evolving and bringing about social changes that go beyond past expectations, general discussions on social issues or agendas is becoming more important as a precondition for a positive feedback loop of impact and long-term returns. As diverse ideas on social issues are basis of investor’s or investee’s "intention" in impact investment and they need to be well discussed profoundly by stakeholders.

Taking into account the fact that impact investment market is still in its early and growth stage, the Guidelines are formulated as general and principle-based to encompass and encourage a wide range of efforts, creativity, and ingenuity by market participants. At the same time, by clarifying principle-based but still core and internationally-consistent elements for impact investment, the Guidelines aim to create an environment in which investors and financial institutions could more comfortably invest their funds to companies, without concerns about so-called washing, and companies could effectively procure financial and business support.

It is also important, as described in 4.3 (3), the Basic Guidelines would be utilized for fostering further corporations among stakeholders.

(2) Scope of the Basic Guidelines

Impact investment is an investment that intends to realize both "social or environmental impact" and "financial returns." Therefore, as far as investee and intended impact are specifically specified and committed, impact investment can be applied across sectors.

Based on the understanding that the fundamental concept of investment that realizes both social or environmental impact and financial return would in principle be the same regardless of investment areas, entities, or asset classes, the Guidelines incorporate a broad range of impact investments without limiting the scope.

Investees include a wide range of industries, sizes, life stages including listed and unlisted companies, operating areas and so on. The scope of investors are not limited either, as various entities such as asset owners, financial institutions, venture capitals, private equity funds, and foundations have entered the market. Asset classes can also vary, such as equity (listed or unlisted), debt (loan or bond) and real assets, depending on the investors' strategies and the characteristics of investees' businesses. Thus, the term "investment" used here is not limited to listed or unlisted markets, and includes loans and other financial products.[35]

In any case, appropriate combinations of businesses areas, investees, and asset classes according to the level and balance and timeframe of social or environmental impact and financial return would be important. Diverse considerations by market participants would be essential in this regard.

(3) Principles for Impact Investment

In order for an investment to achieve both "social or environmental impact" and "financial return," it is necessary to (1) clarify in advance what impact and financial returns are to be achieved through the investment ("intentionality"), (2) what impact and financial return are concretely to be realized result from the investment ("additionality"), (3) confirm these impact even after the investment and take ongoing actions ("identification, measurement, and management"). Furthermore, (4) innovation that could reduce the costs associated with generating social or environmental impact and reconcile or integrate the impacts and returns would be indispensable.

Innovation here includes the introduction of inventive ideas and technologies, transformation of business models, and creative ingenuity that differentiates from existing markets. Corporations range from unicorns that are aiming for rapid growth in response to global challenges, to those who are anticipating moderate but sustainable growth by focusing on the issues and needs of specific regions and niche markets.

Based on diverse possibilities, the entire investment processes of "intentionality," "additionality," and "identification, measurement, and management," should entail sufficient dialogue among investors, financial institutions, and companies, so that the stakeholders would understand how the business of the company develops and cultivates the market and realizes tangible impact in both social/environmental and financial aspects, as well as encourages the company’s novelty that enables the changes in the market and customers.

[35] Even in discussions on international impact investment, etc. referenced in this draft basic guideline, investment targets, asset classes, etc. are not basically limited, although some targets and investment methods may be emphasized in some cases.

Principle1 (intentionality): intended "social or environmental impact" and "profitability" is clarified

➢ As an investment that aims for both social or environmental impact and financial returns, clarify both the social or environmental impact and financial return intended to be realized through the investment. ➢ Present strategies and policies for investment and dialogue to achieve intended target. In addition, through the strategies and policies, specify how the business of the investees will develop and cultivate markets, gain their support, and realize both social or environmental impact and financial returns, including cases where impact and returns would be realized over the long term. ➢ When establishing an investment fund for the purpose of creating social or environmental impact, clarify such strategies and policies on a fund-by-fund basis. ➢ Cleary position the intended targets of investments in relation to the business strategy and investment policy of investors and financial institutions. ➢ Confirm that the business intentions of an investee is basically consistent with those of investors and financial institutions, and examines policies for follow-ups with the investee. ➢ When making investment decisions, consider secondary effects that differ from the "intention" of the investment.

<Approach>

■ **Setting Intention**

"Impact investment" aims to realize both social or environmental impact and profitability through investment. Therefore, it is important for investors and financial institutions to clarify in advance their intention on what impact and financial return they realize through investment. As every investment usually leads to social or environmental impact to some extent through the provision of funds, impact investment is premised on the existence of the intention to realize the impact concretely and proactively.

In particular, it is important to specify the strategies and causal pathways[36] of how investment and business contribute to changes in society or the environment, and to ensure that the "impact" and "financial return" are consistent throughout the investment processes, including market and business prospects.

In addition to investing in individual businesses, there may be cases where "impact" and "profitability" should be realized by investing in multiple businesses through an investment fund or by other means. In these cases, in addition to investment "impact" and "profitability" on individual businesses, it is considered necessary to clarify the objective or intention of the social or environmental impact and profitability that would be achieved by the fund as a whole.

■ **Relationship with Business Strategy**

[36] In general, they are also called "Theory of Change", and would often invite explaining in detail processes and mechanisms through which investment produces impact or changes in societies or environments.

In order for market participants to accurately understand the certainty ’investors' or financial institutions' business strategies or investment policies.

This does not necessarily imply that Investors and financial institutions engaging in impact investment have to perform other investment or business activities that directly take into account social or environmental impact. However, that investors and financial institutions appropriately explain how they align an individual social or environmental impact they aim for through the impact investment in their overall business strategies will facilitate stakeholders’ understanding of the intention of the investment. In addition, there are some cases where investors and financial institutions are trying to change their entire business and investment to be impact-oriented, in which case, understanding and leadership by management is particularly important.

■ **Policies for Dialogue**

The "Intention" in the Basic Guidelines refers to the "intention" of investors, financial institutions and other fund providers. At the same time, as an ultimate entity to realize impact is an entrepreneur or a business, it is important to confirm that the entrepreneur or the business has its own intentions to resolve issues and realize business potential that would be basically consistent with the fund providers’ intentions.

Although intentions of an investor and an investee need not to completely match, their basic consistency would be important for achieving impact and return the investment intends to realize. It is important for the fund provider to clearly state its own intentions and to confirm through dialogue and other means, investee’s management philosophy ,or purpose, strategy, business plan, or intensions behind them. It is especially important to have a constructive and careful dialogue on whether the entrepreneur’s or business’s intention to solve social or environmental issues is reflected in its business plan in a way that leads to the creation of corporate value. Fund providers may need to examine their policies for dialogue, so that they could continue thereafter to understand diverse pathways for companies’ value creation and to realize impact and financial return.

■ **Consideration of unintended "impact"**

Apart from social or environmental impact investors intend to realize, there may be secondary effects of investments, such as adverse effects on other environmental issues as projects progress (e.g., the introduction of a new large-scale facility may reduce greenhouse gas (GHG) emissions, but the facility will have an unavoidable impact on the ecosystem).

There are various types of secondary effects, such as those related to fundamental human rights, those that could be substantially reduced by alternative measures, or those that are easy to quantify or not. In any case, it is necessary to gain the understanding of stakeholders concerned that comprehensive and sufficient social or environmental impact would be obtained through the investment, and if there are serious negative impact, to mitigate or prevent the negative impact, without offsetting with intended positive impacts.

As a precondition for making an investment, it would be important to understand from a bird's eye view what positive and negative impacts the investment or project will have on society, and to proceed with measures to deal with such impacts.

Principle 2 (additionality): additional impact is expected through the investment

- Specifically expect and plainly explain investee’s "social or environmental impact" and "financial return," which would not otherwise be foreseen without the investment, including cases where they are realized over the long term.
- Endeavour measures to create additional "social or environmental impact" and "financial return" through investment, not only through financial supports but also through non-financial supports such as engagement.

<Approach>

■ **<u>Generating impact through investments</u>**

In order to fulfill social or environmental impact and financial return, an investment needs to make a concrete contribution to investee company’s or business’s impact creation and business enhancement, which otherwise had not been realized without the investment. In order to demonstrate the specific impact of investment, it is important to clarify in a concrete and easy-to-understand manner how the investee's business develops into the market and leads to the achievement of the intended social or environmental impact and return, including cases where they will be realized over the long term.

It should be noted that time frame necessary to resolve social or environmental issues and secure businesses opportunities, or an ultimate growth targets or potentials vary from company to company and from business to business. Similarly, the relationship between "social or environmental impact" and "financial return" would vary, depending on business areas and growth stages of the company, and would even evolve over time.

■ **<u>Dialogue to materialize investment impact</u>**

Through dialogue with investees in practice, it is important to proceed to implement financial and non-financial support planned in advance.

Dialogue with investees to materialize the intended impact and business targets would preferably need to consist of comprehensive points of view, including a company’s business strategies, intended impact and profitability, and ways to cooperate with the company’s stakeholders. After all, providing supports or advices, before or after investment, to improve business feasibility as necessary by, for example, offering broad perspectives or addressing companies’ shortages of human resources or expertise. Non-financial support should also be included in additionality of investment’s impact. When deemed beneficial for creating additional impact or promoting business potentials, cooperating with other investors and financial institutions in engagement may be of further help.

Principle3 (Identification, measurement and management of impact): Identifying, measuring, and managing impact

> - "Identify, measure, and manage" in quantitative or qualitative terms impact and profitability to be realized through investment.
> - Specifically, identify the characteristics, size, and potential of the market, and measure and manage "social or environmental impact" or "financial return" on an ongoing basis, including after investment.
> - Ensure that the method used for identification, measurement, and management, such as indications, is objective, for example, by utilizing an internationally established framework.

<Approach>

■ **<u>Approach to Identification, Measurement, and Management</u>**

In order to realize the objectives of impact investment, it is necessary to continuously measure and manage after the investment whether financial and non-financial support planned in advance has actually been provided to the business, whether there has been any achievement in business enhancement of impact creation.

Therefore, it is important for investors and financial institutions, at the individual investment or investment fund level, to identify the impact and profitability they wish to materialize before investing, identify quantitative or qualitative indicators to measure these impact and profitability, and continue to manage these indicators after investment and engagement. While profitability is usually captured quantitatively, there are various quantitative and qualitative indicators for social or environmental impact, which require creativity and ingenuity in each field.

From the perspective of ensuring objectivity, it is desirable to identify, measure, and manage quantitative indicators (KPIs) when quantitative identification and understanding are possible. Nevertheless, given administrative burdens on businesses and the availability of data, as well as the fact that there are some social issues that are not sufficiently fit for quantification, dialogue between businesses and investors/financial institutions would be desirable on what indicators, information and data are suitable and necessary to identify "impact."

When qualitative indicators are used, referring to or combining relevant statistics or other reference figures would be important to ensure objectivity in understanding the impact and provide balanced overall pictures. It is also important to have a long-term perspective that looks ahead after investment by setting quantitative measures for profitability and business feasibility and confirming that the impact will also gradually expand as the business expands.

■ **<u>Ongoing Management</u>**

It is important to continuously monitor the identified quantitative or qualitative indicators after investments and engagement and along with business growth, and utilize them for next actions. There may be cases where intended "impact" are achieved but not accompanied by realizing business potential, or cases where business has grown but the intended "impact" on society or the environment have not been realized. In any case, "Management" is necessary that identifies factors that hinder intended impact or financial return, and consider promoting and engaging on ways to realize impact and financial return subsequently.

Principle 4 (innovation/transformation/acceleration): Support novelty that could lead to accelerate transformations in markets and customers

- Identify and assist the novelty and advantages of investee companies and businesses that could create or accelerate changes in the market and customers, so that investees could generate tangible social or environmental impact as well as financial return.
- Conduct dialogue with investees in a manner that could harness investees' novelty and potential to develop and cultivate and gain supports from the market.

<Approach>

■ **Innovation to create a positive feedback loop of social or environmental impact and returns**

In order to realize the objectives of impact investment, it is necessary to continuously measure and manage after the investment whether financial and non-financial support planned in advance has actually been provided to the business, whether there has been any achievement in impact creation or business enhancement.

Social and environmental challenges are diverse, such as aging population with declining birth rate, ensuring diversity and equity in human resources, decarbonization, and conservation of biodiversity, and arise from a complex combination of various economic and social factors and constraints. Generally speaking, solving problems takes time and is often accompanied by certain levels of costs. When solving social and environmental issues through conventional business models, the profitability of the business or investment may be reduced due to likely-higher costs in terms of both time and capital compared to other businesses.

Therefore, in order to realize and balance "social or environmental impact" and "financial return" through investment in a sustainable manner, innovation that advances social or environmental impacts into growth opportunities to achieve both impact and financial returns at the same time would be necessary.

Innovation here includes the introduction of innovative ideas and technologies, the transformation of business models, and originality and ingenuity that differentiate conventional markets. This may include cases where listed companies for instance utilize the technologies of local impact start-ups and other social- or environmental- oriented local businesses, and interact with each other to produce significant overall impact and business opportunities (inter-company or open innovation).

Innovations may not only realize a positive feedback loop in which "impact" and "financial return" complement, strengthen and balance each other, but also may sometimes even achieve "synergies" between impact and financial return, in which products and services effectively addressing social or environmental issues would acquire large further larger markets.

In order to materialize these relationship, it is essential to what innovation, novelty, or technological and business model reform an investment may create to achieve impact and corporate value enhancement, as well as strategies and causal pathways that will make these changes possible.

Therefore, what counts for impact investors and companies alike would be, to observe diverse possibilities and medium- to long-term perspective, identify strategies and casual pathways on how an investee's business would realize impact and link it to business value, and to engage with mutual dialogue to elicit innovation.

It is important that investors and financial institutions appropriately evaluate and support investees' practical ability to convert the creation of social or environmental impact into the improvement of corporate value.

■ **Dialogue between investors / financial institutions and companies**

In order to realize a positive feedback loop in which "social or environmental impact" and "financial return" complement and strengthen each other, it is necessary not only to consider intentions and strategies for the realization, but also to have good birds-eye for competence and ingenuity to actualize the upward cycle. Identifying, measuring, and managing the important social significance or impact of a project does not necessarily ensure the sustainability of the project by itself. Therefore, investors and investees would preferably need to progress effective dialogue to uncover new technologies, business model reforms, or other innovation that were not envisioned previously and cultivates markets.

Business projects are carried out by investee companies based on their own judgment and responsibility. An investor could in parallel improve the sustainability of their own investment by encouraging improving the "impact" and "financial return" of the project through financial support and engagement.

Investors and financial institutions are thus expected to actively engage in dialogue and other efforts to support the ingenuity of businesses. In doing this, since the strategies and causal pathways and timeframes for achieving the intended "social or environmental impact" and "return" vary depending on each business model, it is desirable to take appropriate approaches accordingly to an individual company.

4. Direction of Further Measures to Promote Impact Investment

Encouraging and supporting companies working to realize social or environmental impact and growth opportunities is in the process of expansion. It is therefore important that investors, financial institutions, companies, and local governments, etc. work together to foster a common understanding that there are numbers of financial impact and business potentials in many young and mature companies, and on the ways impact investment could extract these potentials and encourage innovation works for impact.

Given that the market is still in its early stage, the role of public sector is also important, to provide certain supports in promoting common understanding and accumulating cases in order to respect and support private sectors' initiatives.

From this perspective, in order to encourage investments and corporate activities in collaboration with a wide range of stakeholders, it is important for the JFSA to formulate the Basic Guidelines as a foundation, or infrastructure for promoting impact investment. The Working Group also emphasizes the importance of establishing a forum for dialogue, namely Consortium, where various related stakeholders, including investors, financial institutions, companies, and local governments would gather to discuss ranges of practical issues impact investments and businesses have on an ongoing basis.

Within the Consortium, through public-private partnerships various measures can be discussed and promoted, such as sharing case studies and indicators (KPIs), and other measures including those described below.

[Develop foundation or infrastructure for investments]

(1) "Basic Guidelines" and Fostering Common Understanding

As impact investment that seeks to realize social or environmental impact and opportunities encompass many ideas and market participants, at present there would be no sufficient common understanding among market players regarding "impact investment". Therefore, the promotion of impact investment would be premised on the penetration of a broad understanding of basic concepts and principles.

The Basic Guidelines in this regard tries to illustrate basic concepts and principles. It is, however, necessary to actively communicate and engage in dialogue with diverse and dense market participants from drafting stages toward the finalization of the Basic Guidelines, given the fact that impact investment market is still in its early stage but it embraces varieties of understanding by related parties varies. The nature and objectives of the Basic Guidelines are to clarify the basic principles and provide a foundation for dialogue among investors, financial institutions, companies and other stakeholders involved. It is appropriate to flexibly and continuously improve and expand the content of the Basic Guidelines even after the formulation, according to market developments.

(2) Establishment of a Forum for Dialogue: Consortium

In order to encourage the flow of investment and the efforts of companies to improve sustainability through addressing social and environmental issues, it is appropriate to establish a "forum for dialogue, or Consortium (tentative name) to discuss practical issues of impact investment with the participation and cooperation of various stakeholders from the public and private sectors such as investors, financial institutions, companies, academia, local governments, and relevant ministries and agencies, etc.

In collaboration with international organizations and initiatives, the Consortium could possibly develop data on social or environmental impact, share case studies and types of providing financial and non-financial support, and develop investment methods, expertise, and human resources, as described in (3) below. In any cases, lively discussions and creativity by private entities should be essential.

To this end, it is appropriate for private sector to take leads in sharing knowledge and other initiatives, while public entities such as the JFSA propose and support the establishment and operation of the Consortium by related parties. It is also important to continuously discuss cooperation and role-sharing between the public and private sectors. Besides, while encouraging corporate/investor collaboration, the discipline of both investment and corporate management should be kept in mind.

(3) Direction of Further Measures to be Discussed and Realized through the Consortium

Based on the above, the further measures described in the following summary table, (i) - (vii), may be considered in the Consortium.

Direction of further measures to be realized mainly through the Consortium (Overview)
1) Development of data, indicators, and cases (i) Collection of statistics, indicators (KPIs), primary data, and cases
2) Formation of expertise and development of human resource for financial support and project evaluation (ii) Diversification and flexibility of financial support (iii) Forming expertise and developing human resources related to impact measurement and management (iv) Support for business operators including entrepreneurs
3) Producing actual investment projects (v) Participation of diverse investment entities and matching
4) Promoting impact investment in a region (vi) Support for local companies
5) International consistency (vii) Ensuring interoperability with international principles, data, indicators and other elements.

[Development of data, indicators, and cases]

(i) Collection of statistics, indicators (KPIs), primary data, and cases

As pointed out by the Working Group, a concept of data can be roughly classified into three categories as follows:

- Macro data (such as statistics) that captures issues in Japan and specific regions and the overall situation, such as the "average age in Japan/region," "percentage of the elderly population in Japan/region," and "working hours of caregivers in Japan/region," if in the field of nursing care.
- Indicators (such as KPIs) to measure social or environmental impact in the same field, such as "reduction rate of working hours of nursing care workers" and "average weekly working hours per worker."

・ Data (such as primary data) that measures social or environmental impact of individual investments, such as "the historical number of working hours of nursing care workers in investees and the reduction rate after the investment" and "the realized average weekly working hours of investee companies before and after the investment"

Issues or opportunities with collecting data and expertise are pointed out, for example,
・ The further development of statistics and other information on issues in countries and regions would enable the severity of social and environmental issues to be widely visualized, and will contribute investors to recognize and develop impact investment strategies and areas with high needs.
・ Aggregating and sharing KPIs to be measured will lead to the accumulation of expertise on the identification, measurement, and management of impact for both companies and investors.
・ The aggregation of individual primary data and investment cases is useful not only for clarifying the impact realized through impact investment, but also for specifically understanding the series of processes for realizing social or environmental impact and business growth through investment, such as the target industries, scales of investment, investment methods used, ideal forms of engagement and strategies.
・ In particular, it often takes time to realize social or environmental impact, and it is useful to accumulate and share case studies on how to understand the realization of future impact and growth potential as a long-term investment.

International organizations or initiatives promoting impact investment are already considering and improving the consolidation of statistics, KPIs, primary data, and investment cases[37].

Through the "Consortium" in Japan, data, indicators, and case studies will be collected and shared, and issues for which impact investment is particularly effective and which are easy for investors and business operators to address need to be identified. Encouraging investment from and into Japan through collaboration with global networks is essential, by incorporating knowledge and experiences abroad, including regional cases, as well as by introducing Japan's social issues, investment cases, and companies to the world. It is important to share the recognition of cases in which social or environmental impact and business potential will be realized in the long term through the collection of such data and cases. In addition, as it is not easy to find strategies and causal pathways that realize both impact and financial returns through investment, it is important to deepen discussions on ideas and approaches through collecting case studies.

We should promote impact investment by collaboration with global data, indicators, and cases, at the same time using materials which have been developed domestically, such as "Examples of Indicators for Social Benefits of Social Projects" formulated in July 2022, "The Study Group on Impact Investment for Global Health Final Report" formulated in March 2023, and social issues arranged in the Practical Guidance for "Social Impact Real Estate"[38]

[37] E.g., IRIS+ (GIIN) as a particularly compiling relevant KPIs

[38] Final Report of the Study Group on "Impact Investment and Global Health", Health and Medical Strategy Office, Cabinet Secretariat; "Practical Guidance for 'Social Impact Real Estate'", Ministry of Land, Infrastructure, Transport and Tourism

[Development of Expertise on Financial support and Business Evaluation and human resource]

(ii) Diversification and flexibility of financial support

Although it may take some time to monetize businesses that create social or environmental impact, it would not always be easy to evaluate long-term corporate value and take risks based on the evaluations.

Equity investment are usually expected to generate large returns for investors if its business potential grows significantly at the time of exit.[39] On the other hand, there may be challenges in matching investors and investees regarding the period until the exit of funds. The period is generally considered to be five to seven years especially in Japan, which may pose particular issues for companies to realize social or environmental impact.

In addition, it is important not only at the time of fund raising but also at the time of exit or thereafter to gain understanding from a wide range of investors about strategies and business models that realize return through addressing social or environmental issues. It may be also important to continue to evaluate whether social or environmental impact lead to corporate value after listing and to deepen knowledge by grasping actual cases of so-called "impact IPOs."[40] Enhancement of evaluations at Initial Public Offering (IPOs) and thereafter will also provide suggestions and incentives for unlisted companies that plan to progress their social- or environmental- oriented business models.

On debt finance, loans and bonds, have the advantage of being able to raise funds on a long-term and continuous basis through refinancing, companies usually need to repay loans and bonds on a regular and fixed basis as originally planned regardless of realized sales or profits.

Therefore, it is also important to examine further with respect to funding, such as considering methods to effectively combine the advantages of both equity and debt according to strategies and characteristics of the company and time frames for monetization.

In any case, how to incorporate business characteristics such as "social or environmental impact" into corporate value evaluation is not an easy but fundamental issue, which needs further study at the Consortium and by other means.[41]

(Flexibility of Private Equity Exits)

In Japan, 80% of exit strategies of start-ups that have received investment are IPOs. Given the need to stimulate M&A in order to diversify exit strategies, measures to develop secondary markets are being considered and implemented.

In particular, it is important to consider evaluation methods that take into account the characteristics and growth potential of companies that attempt to create solutions to social

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39 An event in which a founder or investors who have invested in a start-up company recover their investment funds by selling their shares through an IPO or M&A.

40 Some observers recognize Impact IPOs as an IPO where a company intending to realize social or environmental impact clarify those impacts and raise funds through otherwise ordinary IPO processes, but there appears to be no established definition of the term at this moment.

41 The Financial Research Center (FSA Institute) has also been conducting a research project on the correlation between benefits and corporate value since the fall of 2022, and plans to publish a discussion paper in 2023.

or environmental issues, as it often takes time to gain a business outlook. Relevant discussions at present are as follows.

- In international guidelines on fair value evaluation of unlisted stocks by asset management companies, a method for evaluating the fair value of a company in initial stages is introduced, which is based on scenario analysis of the future business potential at the time of investment decision.[42] In Japan as well, it would be useful to consider this as an evaluation method that takes into account mediums - to long-term business potential when evaluating unlisted companies in investment decisions.
- In December 2022, the Tokyo Stock Exchange (TSE) made clear that it amended an evaluation for its listing of R&D-oriented companies a that aim for growth through the use of new technologies in cutting-edge fields (space, materials, healthcare, etc.) and that have received medium- to long-term investment on a reasonable scale from institutional investors, so that those companies, even if they have not yet commercialized its products or services. In such cases, it is clarified that the evaluation of the business model and business environment obtained from the institutional investor's investment decision, together with the evaluation of the level and prospects of technological development, customer demand and costs by a third party expert, shall be used to evaluate the rationality of the business plan.[43]

As for impact investment, in order to make effective use of such framework, it is important to deepen discussions with investors and companies by specifying strategies and causal pathways regarding how to realize business success through technological implementation and business model transformation materializing impact.

(Flexible Financial methods)

Loans are also important financing methods for local companies to raise funds. While numbers of local start-ups do not aim to realize considerably higher revenues than the capital market average, unlike a unicorn company does, many of them in fact aim to achieve higher rate of return in the long term than average local companies, hoping to achieve through various business innovations. Therefore, financial innovations appropriate to these characteristics would be important.

At present, financial methods with characteristics intermediate between equity and debt are emerging in Japan and overseas for regional impact start-ups and other local companies. For instance, there are "loans that require repayments according to amounts of sales." In this case accompany could possibly have easier access to the lending than normal lending even if its cash flows are in deficit since lender could expect increased amount of repayment once the company fulfills its expectation to increase markets and revenues. For another example, there are "loans that requires repayment according to a certain percentage of net incomes" (shared earnings agreement). There are also examples of "investment in which investors can claim dividends according to the amount of surplus on the premise of an exit through acquisition of own shares".

On the other hand, some start-ups, particularly those pursuing rapid growth through innovative technologies, have adopted a "leverage" strategy to increase financial returns for investors, which start-ups raise additional funds through loans to avoid dilution of

[42] International Private Equity and Venture Capital "IPEV Valuation Guidelines" https://www.privateequityvaluation.com/Valuation-Guidelines

[43] 2022 New Listing Guidebook - Growth Market VI Listing Examination Q&A

shares in the event that they continue to raise funds for equipment after initial equity financing. In addition, other start-ups grant share acquisition rights at the time of loan execution to compensate for or strengthen upside returns on loans and to control dilution of shares to a certain extent.[44]

A wide range of possibilities could be explored and shared with regard to these methods' issues, characteristics of companies that match these methods, and specific cases at the Consortium and by other means.

(iii) Forming expertise and developing human resources related to impact measurement and management

For impact investment, it is particularly important to identify, measure, and manage the social or environmental impact of investment. From the perspective of ensuring investment eligibility, it is important to form practical expertise and develop human resources for this purpose.[45] It would also be important for investors and financial institutions to evaluate and support not only the "impact" aspect but also the practical ability to convert these impact into enhancement in corporate value.

However, there are a lot of practical issues with formation of expertise and human resource development; there are various definitions of "impact" for each project; quantitative and qualitative measurements are not easy particularly for social issues; variables can be changed according to changes in surroundings of society; the pathways of project realization may largely vary; and specialized knowledge is required to understand contents of impact.

The impact of individual investments and businesses is highly specific, and uniform methodologies may not always suit for individual case. It is therefore important, for example, to share a) specific case studies that are individually devised based on characteristics such as industry, size, and locality, b) quantitative indicators (KPIs) and qualitative evaluation methods that match the cases, and c) cases of strategies and causal pathways for realizing impact and profitability. It is also important to connect them to programs and personnel exchanges for developing expertise in collaboration with international organizations and academia.

In addition to the formation of expertise among practitioners, it is also important to penetrate the expertise into the management. Through various opportunities toward the finalization of the Basic Guidelines, holding an interactive dialogue on issues of companies and investment that will create a positive feedback loop by linking social or environmental impact to business potential.

In the area of climate change, "the Working Group on Climate Tech Impact Measurement and Management"[46] was established in March 2023 to discuss the technical evaluation of climate tech[47] and the establishment of a framework for evaluating the environmental impact of climate tech. Progress of investors' discussions

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44 Also commonly referred to as "venture debt"

45 Amendment of the Comprehensive Supervisory Guidelines for Financial Instruments Business Operators, etc. regarding ESG Investment Trusts published by the Financial Services Agency in March 2022 also points out the need to develop a system, including the securing of human resources. https://www.fsa.go.jp/en/news/2023/20230331/20230331.html

46 https://www.env.go.jp/press/press_01443.html

47 Technology with the express purpose of reducing greenhouse gas emissions

including such efforts on impact measurement and management methods would be preferable.

(iv) Support for business operators, including entrepreneurs

To foster developing human resources, it is essential to provide not only financial supports but also supports to business operators themselves.

For example, with respect to start-ups seeking business growth while realizing social or environmental impact, the Impact Startup Association was established in Japan in October 2022, attracting a wide range of entrepreneurs. It is important to foster a common understanding of both finance and business by supporting discussions among these organizations and market participants through the Consortium.

In particular, for start-ups, large enterprises, or regional companies that intend to achieve growth by realizing social or environmental impact at the center of their business, various systems and frameworks are implemented and discussed in Japan and overseas; certifying or selecting companies that meet certain requirements[48] in terms of both the growth potential such as novelty and superiority of the business and the status of addressing social and environmental issues. These systems and frameworks are important in evaluating both social or environmental impact and market development.

In addition, support for companies seeking to launch business would be strengthened by utilizing the opportunities for consulting with experts provided by the Organization for Small & Medium Enterprises and Regional Innovation, JAPAN (SME Support, JAPAN).

In addition, the National Entrepreneurship Development Promotion Program[49] and START (Program for Creating Start-ups from Advanced Research and Technology[50]) show a direction to enhance entrepreneurship education, including responses to social and environmental issues.

The role of existing companies such as listed companies, regional companies, and others is also important. It is essential to advance discussions on how to identify the impact of investments and how to engage in companies in listed market, so that new technologies and business model transformations by companies will occur, which lead to the realization of social or environmental impact as well as the enhancement of corporate value.

As discussed in the Working Group, there is still a deep-rooted understanding across various societies that, in general, businesses that realize social or environmental impact have low profitability ("trade-off" relationship between sociality and profitability), and narratives that solving social or environmental issues capture market needs and raise corporate values are not sufficiently recognized.

In this regard, the Japan Business Federation has pointed out the importance of constructive engagement between investors and companies on "value creation stories" developed by companies using "impact metrics."[51] Through the Consortium and other

48 In the U.S., "B-Corp Certification" is issued as an international private certification for good companies with high public interest.

49 https://entrepreneurship-education.mext.go.jp/

50 https://www.jst.go.jp/start/

51 Japan Business Federation "Using Impact Metrics to Promote Dialogue with Purpose as Starting

means, with the cooperation of relevant parties, considering and sharing metrics and case studies on impact-based growth would be important.[52]

In addition, it is important to broaden the understanding of the general public, including individuals, about actual cases of solving social and environmental issues and benefit from to broader social and environmental opportunities, in order to promote impact investment and social businesses.

[Producing actual investment projects]

(v) Participation of diverse investment entities and matching

For impact investment with diverse possibilities and social and environmental challenges, the participation of a wide range of investors, such as institutional investors, financial institutions, corporates, and public entities, and provision of funds through collaboration between these entities (blended finance) are indispensable. Specifically, it would be important to improve various funding approaches under the division of roles between the public and private sectors, as well as for government-affiliated financial institutions to accumulate actual examples and discussions with reference to overseas cases.

In particular, just as the social or environmental impact companies intend to realize are diverse, investors also have various investment preferences, such as risks they can take, financial returns they should aim for, and social and environmental fields they emphasize or focus. It is important to match funds and business projects according to the characteristics of both investors and companies. To this end, the following initiatives are expected to be promoted.

(Asset Owners and Asset Managers)

Asset owners are generally play an important role in the entire investment chain by determining their own investment strategies, selecting asset managers, and developing those asset managers' experiences through engagement. In Europe and the United States, long-term institutional investors such as pension funds and university funds play a leading role in providing funds for venture capital. Similarly, it has been pointed out that asset owners are driving impact investing markets.[53]

The Principles for Responsible Investment (PRI), in its report published in July 2021[54], points out that it is reasonable for many institutional investors to pursue "impact" when

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Point Action for Sustainable Capitalism by Companies and Investors" (June 2022) https://www.keidanren.or.jp/en/policy/2022/060.html

[52] The " Intellectual Property/Assets/Capital and Other Intangible Assets Governance Guidelines Ver. 2.0" (March 2023) also points out that it is important for companies and investors to clearly identify the story of how the social and environmental benefits realized through the investment and utilization of IP/Intangible Assets will capture market needs and lead to corporate value.

[53] The Interim Note for the Working Group on Capital Market Regulations of the Financial System Council (June 2022)

[54] According to the report (PRI, "A Legal Framework for Impact"), "Investing For Sustainability Impact" (IFSI), or investments that intend to promote sustainability through investment could be categorized into the following two types: "instrumental" IFSI, where the realization of social and

achieving goals related to "social or environmental impact" will also lead to the realization of profit targets. In addition, the PRI concluded that the importance of conducting impact investment is significant for large-scale "universal owners" in particular, as the elimination of negative externalities arise from business activities will contribute to the improvement of their overall investment assets.

As for asset managers, some are beginning to set up investment funds that focus on the impact of improvements on social and environmental issues, but compared to those in Europe and the United States, according to several observers, Japanese asset managers are said to tend to have less experiences, knowledge, and operating expertise in impact investing.

The Working Group discussed the relationship between asset owners, who provide funds, and asset managers, who are entrusted to manage funds; even if asset owners are interested in impact investment, investment is not easy in reality without an asset manager with a track record and knowledge, while it is difficult for asset managers to gain experience without first being entrusted by asset owners, and without experiences, even inventive asset managers may not be entrusted investments. For both asset owners and asset managers, therefore it would be important to have a discerning ability to select companies that link social or environmental impact to corporate potential. Developing and exchanging human resources for this purpose are also important.

In overseas, there are interrelated and specialized initiatives to promote asset managers, not necessarily limited to impact investment. For example, government-affiliated funds and public financial institutions are outsourcing a certain amount of asset to emerging asset managers who appear to be creative in various ways. The Tokyo Metropolitan Government, in order to support the establishment and growth of emerging independent asset managers that can lead diverse investment ideas, has been providing its support since FY 2019 by providing partial subsidies for expenses outsourced investment management and other services required at the time of establishment. Over the years, the subsidy program has been expanded to cover a wider range of expenses.

While referring to and utilizing these efforts by local governments as necessary, encouraging creative initiatives of various asset managers, which leads to the creation of new projects.

(Participation and Collaboration of Public and Private Financial Institutions)

The following initiatives are being made and expected to be further promoted with regard to the participation and collaboration of public and private financial institutions.

・ In the review of the scheme for the Utilization of Dormant Deposits five years after the enforcement of the Act, Japanese Government decided to further stimulate private

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environmental benefits is an important "means" to achieve investment returns, or " Ultimate-End" IFSI, where addressing sustainable issues constitutes the ultimate end by itself. The report then states that the former (instrumental IFSI) would be generally possible under fiduciary responsibility arrangements imposed on asset owners, even taking into account the laws and regulations of each country.
https://www.unpri.org/policy/a-legal-framework-for-impact

capital by allowing investment in businesses including impact start-ups in addition to the existing subsidies.[55]

- The Development Bank of Japan plans to promote impact investment through the establishment of a department dedicated to investment evaluation, including impact assessment, and through opportunities for joint investment with regional financial institutions in the future, in order to support companies that are committed to realizing social or environmental impact.
- Japanese Government's The Startup Development Five-year Plan calls for the strengthening of public fund investment in domestic and overseas venture capital and the provision of sufficient equities to realize investment in startups are more than ten times the size over the next five years.
- The Plan also calls for national universities to increase their investment in regional funds in which regional financial institutions participate and to strengthen support for start-ups by regional universities.
- The Tokyo Metropolitan Government has established a Social Impact Investment Fund to invest in start-ups that attempt to resolve issues in the healthcare, medical, and nursing care fields. In addition, it has started to provide subsidies to cover part of the expenses necessary to formulate an evaluation framework for impact investment.

(Meet-up)

Collaboration and meeting up between public and private investors and companies across national and regional borders is also important in order to ensure a wide range of entities participating in various initiatives work together to formulate impact projects. In fact, there are cases in which local companies have benefited from the support of fund providers outside the region who understand the business potential, when expanding into a wide range of markets. There are also examples of Japanese large corporations, European and U.S. manufacturers providing financial support and alliances to small and medium-sized enterprises with high technological capabilities through corporate venture capital (CVC) and other forms. It is important to consider a framework in which public and private investment funds, investors, and financial institutions with various financial characteristics and risk profiles across countries and regions can cooperate and meet up one another through the "Consortium" and other means.

(Diversity of Investment Entities)

According to "Proposals to Solve Gender Diversity Challenges in Japan's Startup Ecosystem" by the FSA Policy Open Lab, only 2% of newly listed companies have female presidents. As a result, there are issues arising from male bias in business creation, such as effects on earnings and various losses that may exist due to lack of diversity. In cases where there is a lack of gender balance, it is conceivable that unconscious bias may prevent the company from fully capturing its true growth and sustainability potential.

Such diversity, including gender balance, in the management of investors, financial institutions and companies, reflect their operational ingenuity, and does not directly define investee's impact via impact investment per se. However, the diversity would generally lead to social or environmental impact and value creations. Social and environmental

[55] Cabinet Office "Policies for the five year Review of the Act on Utilization of Funds Related to Dormant Deposits ", (December 2022)

issues are diverse, and it is important for investors to operate in a way that understand and provide support to companies and other entities that are working to solve these diverse issues.

In fact, there are cases in which, through ensuring the diversity of investment and business players, including the diversity of those who invest and those who receive investment, a) improve the social aspects of their own operations, b) differentiate themselves from other investments by incorporating diverse viewpoints into their investment strategies, expanding the range of companies they invest in or setting those diverse viewpoints as bases of strategies, and c) make diversity one of the factors that bring long-term corporate value creation.

Regarding gender balance, the Gender Equality Bureau of the Cabinet Office has just discussed measures to realize a virtuous cycle between women's empowerment and economic growth, including fostering and supporting female entrepreneurs, at a study group established in 2022. Further efforts will be made based on the recommendations of this study group.

[Promote impact investment in region]
(vi) Support for local companies

Although there are various efforts by local governments and other organizations to support local companies, experts point out that;

- most of the start-ups are concentrated in the Tokyo metropolitan area, and business models that contribute to solving regional or social issues and realizing stable return have not so far widely spread;
- it is not easy to gain an understanding of the start-ups with a large cash outflow at the beginning of the business, especially in the case of local companies.

Furthermore, with regard to the ideal form of the provision of funds, experts state that;

- as the proportion of indirect financing (i.e. bank lending) is especially high in local economies, and currently a large amount of capital funds concentrates in the Tokyo metropolitan area,[56] there have not been so far sufficient equity investors or fund managers active in local markets
- there are some investment funds rooted in the community that support local impact companies, but they are often relatively small, and the expertise and cost burdens for measuring and managing "social or environmental impact" might be their challenges.

On the other hand, as technology advances, there are more and more entrepreneurs in local communities who seek to realize both social or environmental and economic impact, including those with far different growth perspectives and targets from so called unicorns. Similarly in overseas, start-ups that contribute to solving local social and environmental issues are found. In the UK, for example, where more than half of impact start-ups are found outside London.[57]

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[56] For example, of the 47 members of the Impact Startup Association (as of March 2023), 41 are headquartered in Tokyo, and around 80% of start-ups' financing by registered location was raised in Tokyo (as of January 2023)

[57] "UK impact startups raise £ 2 billion to solve the world's greatest challenges "(November 2021) by the UK Department for Digital, Culture, Media & Sport and other.

In addition, in each region of Japan, there are parties that have long been engaged in supporting to establish and revitalize local businesses, responding to local social issues and improving the sustainability of local economy. These would have many points in common with the concept of impact investment.

Moreover, there would certainly be cases where existing businesses could lead to impact creation and innovation, including cases where a company's existing products, services, and technologies have increased their potential corresponding to emergence or changes of social and environmental issues.

Building on these various existing efforts, identifying and visualizing social or environmental impact and its potential to local societies would conceivably deepen the initiatives to create opportunities and revitalize local economies.

In doing so, collaboration among investment funds, industrial and financial organizations, universities, local governments, and organizations working to revitalize local companies through the "Consortium" and other means would be of high importance. Active engagement, collecting case studies and issues, sharing expertise on financial and non-financial support for local impact businesses, including locally-fit KPIs and other issue-based investment methodologies are potential issues to be discussed.

In addition, in order to secure human resources for local companies, for example, the "Project to promote the matching of human resources for regional corporate management, "[58] which creates a flow of people from large companies to local small and mid-sized companies through regional financial institutions to encourage regional enterprises to secure management personnel, could promote dispatching personnel to small and mid-sized companies, including local companies that contribute to solving social and environmental issues in the region.

The role of regional financial institutions is also important, such as investing in funds to support local companies as well as promoting business feasibility assessments and accompanied support for problem solving. For example, it would be effective to identify issues and support how to address those issues when regional financial institutions intend to make impact investments in local companies.

As for financial institutions' equity investment in local companies, the amendments to the Banking Act and its Enforcement Regulations, which came into effect in November 2021, expanded the scope of exceptional measures to allow financial institutions to invest more than 5% in companies with respect to the limitation on the holding of voting rights in banks (so-called the "five percent rule"). In addition, it was clarified that financial institutions are not subject to high risk weight as speculative unlisted stocks if they meet

[58] The Regional Economic Revitalization Corporation of Japan (REVIC), a joint-stock company in which the Japanese government also has a stake, has established a human resources platform called "REVICareer" to connect large corporations with regional financial institutions that provide human resources to small and medium-sized companies in the region, with the aim of supporting regional revitalization and business recovery, etc. REVIC provides benefits to regional companies that have secured human resources. Training and workshops are also provided for large corporate human resources to understand local conditions and the business realities of small and medium-sized enterprises (SMEs).

certain requirements regarding long-term characteristics and business relationships with customers[59][60].

Furthermore, with regard to loans, consideration is underway for the establishment of a legal system that would allow a company to raise funds from financial institutions by pledging its entire business, including intellectual property and intangible assets, as collateral. There is thus room for utilizing this system for start-ups with no tangible assets but with future prospects.[61]

Regarding the use of intellectual property and other intangible assets[62], based on the "Intellectual Property/Assets/Capital and Other Intangible Assets Governance Guidelines[63]" revised in March 2023, not only regional companies but large enterprises are to provide intellectual property and human resources to start-ups, large enterprises, or regional companies and to take specific actions to invest in and utilize intellectual property and intangible assets that contribute to solving social issues.

Positive impact finance (PIF), an investment without specifying the use of proceeds is spreading mainly in regional finance in Japan. Through PIF processes, an investor analyzes and evaluates the economic, social, and environmental effects of corporate activities based on the Principles for Positive Impact Finance (2017) advocated by the United Nations Environment Programme Finance Initiative (UNEP FI), usually not limited to a particular use of proceeds.

There are cases, mainly in Japan, where PIF to small and medium-sized local enterprises is made as part of support for business growth and corporate value enhancement through social or environmental impact. This Working Group has compiled a draft Basic Guidelines based on various experiences including those on PIF. As the relationship between the realized impact and business potential is diverse also in PIF, it would be important for financial institutions and companies to individually and specifically examine and judge the significance of such relationships. Various considerations, ingenuity, and creativity would be important and expected in this regard.

[International consistency]

(vii) Ensuring interoperability with international principles, data and indicators

It is important to develop a framework for impact investment that is consistent with international discussions, including those among large investors with a wide range of stakeholders, and to consolidate investments and other activities in line with this

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59 JFSA, "FAQ on Capital Adequacy Regulation" (updated in July 2022)

60 In the " Grand Design and Action Plan for a New Form of Capitalism 2023 Revision" (June 2023), it is stated that the Banking Act's capital injection regulations will be relaxed in order to expand the scope of start-ups in which banking groups can invest from the perspective of broadly supporting the development of new business fields, with start-ups that require time to grow in mind.

61 Summary Report of the Working Group on Legal Institutions for Cash-flow-focused Lending Practices (February 2023)

62 Revisions to the Corporate Governance Code (June 2021) include disclosure of investments in intellectual property and human capital as well as effective supervision by the board of directors.

63 Intellectual Property/Assets/Capital and Other Intangible Assets Governance Guidelines ver2.0

framework, in order to secure international credibility and to allow investors, including Japanese ones, to invest with confidence both in Japan and overseas.

Impact investment has been discussed in the United Kingdom and France including government organizations, and in the United States, various organizations such as the Rockefeller Foundation and GIIN have led the discussion. As described in Reference 1, the proposed Basic Guidelines have been formulated so as to be consistent with the discussions of such organizations. Principle 4 is described as the principle to achieve both social or environmental impact and financial return, however, as seen in the initiatives referred in Reference 1, that investment entails novelty which would create meaningful impacts and profits seem to be a rather preconditioned feature of numbers of private investments including overseas.

In any case, in the course of formulating the Basic Guidelines and the implementing various measures, it is essential to actively engage in dialogue with international organizations and initiatives to ensure mutual understanding and cooperation.

Data, indicators, and case studies are also being examined and implemented by various organizations. While the Consortium will be examining data, indicators, and case studies that meet Japan's challenges, it is worth considering connecting those to international tools and indicator databases[64]. In this way, references cases, including regional cases, could be shared among Japanese stakeholders, and equally Japan's social and environmental issues, such as the declining birthrate and aging population, as well as data, indicators, and examples in response to these issues, would be disseminated internationally, which could potentially attract wider investors globally.

[64] E.g., IRIS + (GIIN)

Reference

(Reference 1) Understanding impact investment overseas

The Global Impact Investing Network (GIIN), an international network of impact investment established by the Rockefeller Foundation in 2009, states that all investments have impact, but in particular, "investments made with the intention to generate positive, measurable social or environmental impact alongside a financial return" are considered to be impact investments. Following requirements are included:

1. Intentionality to generate an impact (different from general ESG investing or screening strategies in that it aims to contribute to solve issues through investment)
2. Financial returns on capital (different from philanthropy in that it seeks financial returns that can range from below market rate to market rate).
3. Range of asset classes (made across asset classes)
4. Impact measurement (committing to measure and report the social and environmental performance of investments)

The Government of the United Kingdom established the G8's "Social Impact Investment Taskforce" under its presidency of the G8 in 2013. It positioned impact investment as "finance that contributes to public benefits as well as startups and innovation" and made recommendations such as setting and monitoring measurable performance targets in implementing social projects, considering the "social impact" in addition to risks and returns for investors, and clarifying that social returns can also be considered under the responsibility of a trustee. The Task Force was succeeded by the Global Steering Group for Impact Investment (GSG) in 2015 and it continues the work as an international network.

In 2017, the Government of France launched a forum in which French companies, financial institutions, and relevant ministries and agencies participate. The forum stated that impact finance is an "investment or financing strategy that aims to accelerates the just and sustainable transformation of the real economy, by providing evidence of its beneficial effects and contributes to the realization of a sustainable society and economic activities" that goes beyond conventional ESG investment, and that requires intentionality, additionality and impact measurement. In addition, while ESG investment is a method for negative screening and risk management, impact finance is a proactive process for transforming portfolio companies. Although ESG analysis is the foundation, it is organized as a different investment approach.

In 2019, the International Finance Corporation (IFC) launched the "Operating Principles of Impact Management," which set forth principles for investment management requirements and investment processes that are considered to be commonly applicable in implementing impact investment, while leaving the significance of impact investment and differences from other investments to the judgment of investors.

(Reference 2) Various methods and financial products for sustainable finance

ESG integration

A strategy in general that incorporates ESG factors into financial analysis and investment decisions. Specifically, there is a method for incorporating decarbonization strategies, diversity of employees, enhanced disclosure, and other factors that are highly important to the company in three categories of "environment," "society," and "governance" in financial analysis such as cash flow forecasts and discount rates. This is reflected in corporate valuation and linked to investment decisions.

Negative and positive screening

Based on specific ESG criteria, including ESG ratings and indexes, there are investment strategies that focus on the industry, business, and governance of a company and do not invest in companies with particular issues (negative screening), or strategies that select to invest in industries and companies that are particularly highly rated from an ESG perspective compared to other companies in the same industry (positive screening). According to Global Sustainable Investment Alliance (GSIA), an international ESG investment promotion organization, "normative screening" is similar to the former, and "thematic investment" is similar to the latter, but "negative screening" accounts for the largest part of investment.

Both ESG integration and positive / negative screening generate the impact and promote growth of investment through the overall management of portfolio companies. However, they do not necessarily grasp and measure the social or environmental impact of individual investment in individual companies.

In addition to general ESG investment as described above, the following investment methods and products exist with guidelines and individual labels in each field.

Green Finance

Green Bonds and Green Loans are investments and loans to raise funds specifically for efforts in the environmental field, such as climate change, biodiversity conservation, and resource circulation. Funds should be allocated to "Green Project with a clear environmental benefit." Guidelines issued by the Ministry of the Environment (MOE), the International Capital Market Association (ICMA), and the International Loan Market Association (LMA) gave examples of green projects.

Climate Transition Finance

A method for raising funds based on a transition plan prepared by a company to make a transition toward decarbonization. When fundraising by issuing bonds or loans, it is common to individually confirm that the requirements such as strategies and governance, scientific base, and transparency are satisfied based on the "Basic Guidelines on Climate Transition Finance" issued by the FSA, METI, and MOE, and give the label to the fund. The scope of projects and economic activities is not necessarily limited, and individual products may overlap with "green" and "sustainability link."

Social Finance

A financing method for projects aimed at solving social issues. Although the use of funds be limited to social projects (projects that have clear social impact on specific social issues), guidelines do not limit the use to specific business fields. Basic concepts, representative cases, and KPIs are presented in the Financial Services Agency's "Social Bond Guidelines" and "Examples of Indicators for Social Benefits of Social Projects".

Sustainability-Linked Finance

A method in which a fund raiser sets KPIs and performance targets related to sustainability in advance and raises funds to achieve these targets. In many cases, interest rates fluctuate depending on the degree of achievement of the targets.

Guidelines issued by MOE, ICMA, and LMA have established requirements for processes such as evaluating and measuring targets, verifying them by a third party, and disclosing the results. However, the use of funds is not limited, and companies can set targets in accordance with their own sustainability strategies.

(Reference 3) Fund Name's Rule and Disclosure Regulations in Europe and the US

Mainly in Europe and the United States, from the viewpoint of encouraging sound market development by ensuring investor protection and market discipline, regulations that impose requirements such as asset composition and disclosure on investment funds that use sustainability-related names including "impact" have been examined and implemented as follows.

For Japan's Supervisory Guidelines, please refer to page 13 of this report.

Note that the "Basic Guidelines on Impact Investment" proposed in this report are different in nature from these regulations. Basically, from the viewpoint of promoting investment, the "Basic Guidelines" show the basic concept and key elements when investors make impact investment, and create a common understanding among market players.

Development in the European Union (EU)

In the EU, the Sustainable Finance Disclosure Regulation (SFDR) has been applied since March 2021, and disclosure related to investment funds has also been implemented since the beginning of 2023.

The SFDR classifies general funds provided in EU into Articles 6, 8, and 9. Financial instruments that promote environmental or social characteristics but do not aim at sustainable investment are referred to as Article 8 funds, financial instruments that aim at sustainable investment are referred to as Article 9 funds, and other funds are referred to as Article 6 funds. The SFDR stipulates certain requirements including those for disclosure according to the classification.

Financial institutions and funds that provide these funds in EU, including Article 6 funds, are required to disclose their investment policies based on sustainability risks, as well as pre-contract documents (prospectuses), regular reports to investors, and website disclosures to the public for each product. In particular, Articles 8 and 9 funds are required to additionally disclose their definitions of sustainability and the proportion of assets meeting the definitions according to the classification. In addition, regarding the asset classification, in the case of investment funds that advertise sustainability in its name, more than 50% of investment assets are required to be assets conforming to the EU taxonomy. Impact investment is generally classified into Articles 8 or 9 as investment that promotes social characteristics and sustainability. However, many point out that the classification of both Articles is not always clear, and practical exploration is continuing.

Developments in the UK

In October 2022, the Financial Conduct Authority (FCA) of the United Kingdom (UK) consulted on the name of sustainable investment and proposed disclosure requirements regarding the UK's Sustainable Disclosure Requirements (SDR).

According to the draft regulations, sustainable investment is defined as investment that accounts for 70% or more of total assets, investment in assets that have the potential to become sustainable in the future, and investment that aims to achieve predefined and measurable environmental and social effects ("sustainable impact"). In accordance with this classification, investment funds are required to disclose the purpose of sustainability, KPIs that measure the progress of the purpose. In the case of "sustainable impact" investment, it is necessary to disclose the strategy and theory of change of the impact materialization through investment and the method of measuring the impact.

Developments in the United States

In the United States, the Securities and Exchange Commission (SEC) announced in May 2022 a proposal to expand the existing fund names' rule regulations. Focusing on an investment fund's investment decisions, those that consider ESG factors in investment decisions but not as a deciding factor ("integration"), those that primarily determine ESG factors ("ESG focus"), and those that specifically seek to achieve impact ("impact"), require additional disclosure in line with their type. For example, in the case of impact fund, disclosure of the impact to be achieved and their assessment methods are required.

(Reference 4) Typical cases considered as impact investment

There are various forms of social or environmental impact and growth opportunities that companies may aim to achieve. Investors also have various preferences for investment, such as the risks they can assume, the financial returns they are aiming for, and the social or environmental areas they would like to focus. It is important to match finance and businesses according to the characteristics or profiles of both investors and companies.

In the following parts, this report describes examples of impact investment that would be considered typical at present. These are cases where the social or environmental impact and growth opportunities companies and investors aim for would be consistent with corresponding financial methods.

All of them are based on actual companies that are seeking to impacts and business potential, however, they are merely categorical examples and are not labeled as 'impact investment' at the time of investment. Obviously, the examples of impact investment are not limited to these, more and more examples should be accumulated and shared through the "Consortium".

For convenience, start-ups and large or listed enterprises are described below separately. However, as pointed out by the Working Group, cases for companies should be examined and shared seamlessly alongside their growth stages including before and after IPOs. In addition, sufficient experience has not been accumulated in Japan for each case including

Case 1, issues are to accumulate and share the experience through "Consortium", going forward.

Case 1: Investing in a start-ups that aims to scale up to meet global challenges

Characteristics

Needs and interest in global issues such as decarbonization, poverty, and education are rapidly growing in a wide range of regions, both urban and rural, domestic and international. In recent years, there has been an increase in the number of start-ups that are committed to contributing directly or indirectly to solving these issues, especially those that derive technologies and business models that will help solve the issues and potentially cultivate markets to a wide variety of producers and consumers, including global markets.

While new technologies and business models may pose challenges, such as requiring considerable time for trial and error, if properly developed and implemented, they could potentially open up large markets both domestically and internationally.

For this reason, as a financial approach, these companies would have relatively high affinity with investments in which interests paid are smaller in early stages of business, their later stages as business grows: typically equity and other venture capitals.

From the investor's perspective, even if the initial return on capital is low, if the business grows substantially and earns a corresponding financial return, high return can be secured over the entire investment period. Also, even if each individual business or investment entails various risks, it could be possible to secure a certain level of profitability for the fund or other investment unit as a whole.

Examples of businesses and investments

Company A, a start-up that develops technology to chemically degrade plastics, has been researching and developing this technology and providing it to plastic disposal and generation facilities as a means to reduce greenhouse gas (GHG) emissions from incineration of plastics and to mitigate the ecosystem effect of oceanic runoff.

The environmental impact of waste plastics has been widely recognized, as specified in the "Technology Roadmap[65]" for the chemical industry in Japan, but the technology for direct degradation has not yet been widely implemented, and the potential for business is expected to be high. Although the technology was not always well received in the beginning, due in part to its specialized nature, the company eventually raised funds from both domestic and foreign investors.

The company discussed with the investors the estimated reduction in GHG emissions that could be achieved by this technology applying to customers in the chemical industry and other sectors, and dialogue on these estimates has continued since the fundraising. The company and investors has shared the understanding that demand is expected to increase due to rising environmental regulations in various countries, and this led to the investment.

[65] Ministry of Economy, Trade and Industry, "Technology Roadmap Formulated for Transition Finance toward Decarbonization in the Chemical Sector" (December 2021) https://www.meti.go.jp/english/press/2021/1210_003.html

Another start-up B has been operating an online platform internationally for school children in an effort to sustainably secure IT human resources, which are in short supply both domestically and internationally. In addition to providing programming and other skills development services to individuals and educational organizations, the platform is also planning to offer services for businesses that provide educational expertise aggregated through AI and other means to companies, schools, and other organizations, which is said to be not much precedent in the industry.

In the dialogue with investors, in addition to the framework of the growth story of the business, the company also discussed the progress of qualitative indicators, such as the welfare of instructors involved in education and feedback from students and instructors, as well as the short-term revenue – earning measures by operating on-site schools by graduate students who have acquired the expertise by the platform. The company provided a consistent explanation of such a wide range of business development, which led to fund-raising.

Case 2: Investing in Regional Enterprises

Characteristics

There is a movement to develop markets and create businesses from the region, such as local start-ups, in response to a wide range of social or environmental issues, including global issues.

As in Case 1, there are businesses that are expected to have significant impact opportunities once they are practicalized. On the other hand, there are businesses that are expected to grow moderately but sustainably by focusing on the issues and needs of specific regions and markets. Their target lends of financial return range widely, so do their types of production or services. For example, some local businesses aim to expand internationally, others provide local technologies and products to the metropolitan area, and still others intend to provide their services mainly to their local area.

Thus, there is no uniform optimal solution as a financial method, but in addition to the investment in the start-ups as seen in Case 1, there are many cases in which loans would be fit for companies aiming for sustainable business growth as their expected rate of return would be lower than that of equity, though incurring payment at earlier stages. Furthermore, there are new businesses that do not necessarily aim for as high rate of return as in usual start-ups, but whose income and expenditure are not as stable from the beginning as in existing businesses. Therefore, financial methods that have intermediate characteristics between equity and loans, such as whose payment is determined responding to growth in profits and sales, could be a useful option.

In either case, there are some issues that are unique to start-ups in local areas, such as differences in business and investment information between urban areas[66], collaboration with local stakeholders, and products and services tailored to local community issues. Therefore, a wide range of perspectives is required for dialogues between these local businesses and investors or financial institutions. Also, it is important to cooperate and match various fund providers, fund raisers and supporting organizations, by utilizing a wide range of digital and remote technologies.

[66] As indicated on page 34, the number of impact startups in regions is considerably lower than that in urban areas.

Examples of businesses and investments

A local start-up C, a livestock producer, plans to carry out business operations that contribute to sustainability. For example, it utilizes resources and reduce feed costs by developing forests that have not been effectively used in the area, utilizing its undergrowth as feeds for the livestock. The company projects that the forests grass and soil absorbs and mitigates GHG derived from livestock, which it believes would contribute to the sustainability of the livestock operations. In order to ensure that these characteristics would lead to acquiring consumer needs, the company operates in an integrated manner, from production to wholesale, retail and food and beverage provision by itself, using information technology to manage the process and providing information on animal welfare and sustainability-oriented management in the sales channel.

As demand for sustainable livestock farming is growing rapidly around the world, and sales channels are expanding to include restaurants and bars in local areas, urban areas, and overseas, the company plans to further expand its operation into tourism and service businesses, such as stay-type livestock farms.

While developing forest pastures and introducing livestock and products requires more time than other similar businesses, the effects and business model are relatively clear, thus a wide range of parties, including regional banks, funds by local business community, as well as large private investors and financial institutions in urban areas, have shared the intention on impacts of the project and provided financial support.

Company D, which develops and sells health food products, has discovered health- and beauty-enhancing ingredients in the pericarp of local produce and productized them using its own technology. Company D then recycles the pericarp and sells it as a way to reduce negative environmental impact and waste agricultural products. The technology developed in the course of research and development (R&D) is patented as intellectual property, and the types of machinery used for production could be sold to other regions, but continuous research and product development requires corresponding funding and the sequential creation and sale of products. Although further product generation requires a period of research and development, financial institutions with which the company has existing business relationships continue to finance it, as it has already commercialized some of its products and can continue to do so relatively quickly and stably, as well as developing a strong customer base that is interested in reducing environmental impact.

Case 3 Investing in large companies or listed companies

Characteristics

Large and publicly traded companies are also often seeking to realize additional social or environmental impact and business potential by leveraging their existing business expertise or independently deriving new technologies and business models and expanding their businesses in a different way than before. They also have a greater direct impact on society and markets than smaller companies. Given the significant role of the listed stock market in the capital market, including various ripple effects, the promotion of impact investment and funds for listed market would be highly important.

Large companies and listed companies have been making efforts to continuously enhance their disclosures on sustainability and business promotion, making it easier to obtain information on sustainability initiatives. They also have comparative knowledge on sustainability-oriented financing. Findings from various financing frameworks such as stocks, bonds, and loans, as well as from dialogue with stakeholders, can potentially be applied to impact investment.

On the other hand, large companies and listed companies often already have complex funding structures such as capital, bonds, and loans for their current business development. They may be able to realize impact and profits by combining with their existing businesses. In such cases, it is necessary how investors could confirm social or environmental impact and profitability that have been "additionally" generated by their investments needs further examination. Continuous discussions in the "Consortium" are required in this regard, taking into account the characteristics of large and listed companies that facilitate dialogue with investors through disclosure and other means.

Examples of businesses and investments

Company E, which belongs to high-emitting industries, has accumulated track record of finance that contributes to 'climate transition,' including explaining the strategic alignment with the 2050 decarbonization targets set out in the company's own policy. On the other hand, innovative technologies developed by companies may not only reduce emissions in their own supply chain, but also contribute to reductions in the supply chains of other companies, and this may lead to an increase in sales of the technology. In this case, the impact investment approach may also be effective in realizing the environmental impact of society as a whole through investment and in focusing on the increased business potential.[67]

Also, even in the case of a business that is an extension of existing business, there may be cases in which it is particularly easy to capture the creation of impact depending on the location and state of provision of the service. For example, a company F, which provides engineer education, is promoting this business in developing countries using its stable profits from its domestic business. By hiring personnel who have been trained as engineers in-house or by arranging them for other companies, the company aims to materialize the results of the service provision, contribute to educational opportunities and career formation in developing countries, and secure the business potential by providing educational expertise to external parties. These projects may also be able to consider impact investment for the financing.

[67] See page 12 and Reference 3 for the relationship with existing ESG labels such as Climate Transition Finance.