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# Becoming an Advanced ESG Nation

ESG investment – the adoption of a long-term perspective in investing in companies that are actively working to resolve environmental and social issues – is gathering momentum. In Japan, a Stewardship Code was established in 2014, followed by a Corporate Governance Code in 2015, but the initiative towards ESG investment has been taken by other countries, and Japan is only finally beginning to make efforts in this area. What issues will Japan have to resolve in future in order to become an advanced ESG nation? What will be required of companies, and what will be required of investors? In this issue of *My Vision*, five experts who have been at the forefront of the promotion of ESG investment in Japan provide us with suggestions towards answers to these questions.

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### Becoming an advanced ESG nation
### – What are the issues for companies, investors and the market?

Yuri Okina
NIRA Executive Vice President, Vice Chairman of the Japan Research Institute, Limited

Keywords…Fostering of human resources / creation of systems for investors, reform of corporate awareness, disclosure of non-financial data, establishment of market infrastructure, deepening discussion of "E" and "S"

## Expert Opinions

### Becoming an Advanced ESG Nation

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Chairman, Japan Investment Advisers Association

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Executive Officer, Global Investor & Brand Communications, OMRON Corporation

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**Financial institutions must go back to the basics, honing their ability to judge corporate potential when financing**

Keisuke Takegahara
Executive Officer and Deputy Chief Research Officer, Coordination Department, Development Bank of Japan Inc.

Keywords…Lehman Brothers collapse, value creation messages, evaluation of business potential, cooperation between direct and indirect financing

**We should discuss the essence of ESG investment in order to reconceive management**

Rintaro Tamaki
President, Japan Center for International Finance (Former Deputy Secretary-General, OECD)

Keywords…Multinational corporations' guidelines for action, fiduciary duty, CSR, business strategy

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About this Issue

# Becoming an Advanced ESG Nation
## – What are the Issues for Companies, Investors and the Market?

Yuri Okina
Executive Vice President, NIRA / Vice Chairman of the Japan Research Institute, Limited

### ESG Investment: A Focus of Expanding Initiatives

ESG is an abbreviation of environment, society, and (corporate) governance. ESG investment is an approach to investment in which institutional investors focus their investments on companies which make active efforts to contribute to the resolution of environmental and social issues. The influence of this trend is being increasingly felt in the Japanese stock market. The background to the trend is the desire, by means of investment activities, to support sustainable increases in the value of the company that is the target of the investment, and, as a result, to contribute to the resolution of social issues. This is a trend that is expected to expand further, but numerous issues still stand in the way of Japan becoming an "advanced ESG nation." In this issue of *My Vision*, we therefore asked Japanese leaders in the field of ESG investment to discuss initiatives up to the present and directions and issues for the future from the varying perspectives of asset owners, investors, financial institutions, corporations, and international institutions.

### A Changing Japan

One factor that has worked to promote the current global recognition of ESG investment was the United Nations' publication of the Principles for Responsible Investment (PRI) in 2006. The Principles for Responsible Investment urge investors, when analyzing and evaluating companies, to incorporate ESG elements, and to take a long-term perspective and demand appropriate disclosure from the company. In many cases, such investors as overseas pension fund investors have incorporated ESG investment initiatives into their practice in advance of other countries. The outstanding global balance of ESG investment was 23 trillion dollars in 2016, representing close to 30% of the world's assets under management. This figure has grown by 25% from two years previously, and data shows that the majority of this growth is due to European investors. In Japan, the orientation of investors and companies in relation to ESG changed when the Government Pension Investment Fund (GPIF), the world's largest asset owner, became a signatory to the UN's PRI in 2015, and the Stewardship Code was revised in 2017. However, now that companies have largely implemented basic responses to the 2015 Corporate Governance Code, looking at the qualitative elements of ESG we find that they have tended to first prioritize the "G" element, and more than a few companies have yet to formulate strategic initiatives in relation to the "E" and "S" elements.

### Positioning ESG as an Investment Strategy

The first task confronting us in order to make Japan an advanced ESG nation is for investors to position initiatives in the area of ESG investment as an important agenda in their future investment strategies, and to foster the human resources and establish the systems necessary for this. As Hiro Mizuno, the CIO of the GPIF, points out in this issue, companies that do not consider society or the environment represent a high risk as investees, making ESG investment an extremely rational choice. For institutional investors with a fiduciary duty, it is necessary first to recognize the importance of positioning ESG as part of an investment strategy. As Akiyoshi Oba, Chairman of the Japan Investment Advisers Association, indicates here, in the case of Japanese institutional investors which have been strongly oriented towards the short-term, it will be

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necessary to foster human resources capable of gaining an understanding of those aspects of a company's value that cannot be expressed in figures through dialogue with the company, and possessing the power of discrimination with regard to investment choices. In addition, it will be essential to create a system that consistently pushes companies toward the path of sustainable growth. If this can be realized, the attractiveness of investment will increase, ultimately generating a flow of funds from Japanese savings toward investments.

## Enhancing the Disclosure of Non-financial Data and Establishing Market Infrastructure

The second task towards Japan's becoming an advanced ESG nation is, on the corporate side, realizing a change in awareness regarding ESG and promoting the reconsideration of business models based on the disclosure of non-financial data. Tsutomu Igaki of OMRON Corporation indicates in this issue that this will involve the recognition on the part of all companies, managers and company employees that we can no longer separate management and social issues, and active attempts to increase the transparency of management and the visibility of non-financial data. Making non-financial data more visible must be positioned as an important factor in promoting companies to think more deeply about business models that will be sustainable into the future.

With regard to this point, Keisuke Takegahara of the Development Bank of Japan also indicates the importance of information concerning non-financial factors that support financial performance below the surface, for example information concerning a company's ability to generate innovation, the quality of its managers, and initiatives related to corporate social responsibility, and points out that it will be necessary for companies to establish a convincing logic in relation to how the growth of their business will assist in addressing social issues, and to explain this logic to investors and financial institutions which engage in indirect investment.

The third task confronting us is the establishment of market infrastructure. The role of companies that publish indexes will be of particular importance here. It will be necessary for indexing companies to provide guidance to companies by disclosing their methods of evaluation, in addition to publishing results indicating long-term improvement in the performance of companies selected as indexes. This will support the creation of a virtuous circle in which companies that increase their corporate value while fulfilling their social responsibilities are positively evaluated.

## Increasing Awareness in relation to "E" and "S"

It will be necessary for Japan to address these tasks as soon as possible. Overseas, national leaders and central bank personnel such as Mark Carney, the Governor of the Bank of England, are actively making statements regarding climate change. There are other expressions of this trend – for example, the Government Pension Fund of Norway has recently suspended investments in Japanese companies using a high proportion of power from coal-fired power plants. It is clear that global Japanese companies with a high proportion of overseas investors cannot ignore this trend. As Rintaro Tamaki, formerly the Deputy Secretary-General of the Organisation for Economic Cooperation and Development (OECD), points out in this issue, there is a conspicuous lack of discussion regarding such subjects as economic disparity, gender and climate change in Japan, and it is important for us to recognize this difference in the level of discussion regarding ESG between Japan and other nations. What is demanded is ongoing discussion of the issues from an economic perspective, not merely by individual companies, but by Japanese society as a whole.

As indicated above, awareness of the "G" element, which provides the foundation for the "E" and the "S", is steadily increasing in Japan. It is to be hoped that discussion of these latter two elements will be deepened based on a solid foundation of corporate governance, and that the implementation of practical initiatives will speed up.

Dr. Okina is NIRA's Executive Vice President, and Vice Chairman of the Japan Research Institute, Limited. She holds a doctorate in economics from Kyoto University.

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Expert Opinions

# Japanese Companies must Cultivate Information Disclosure Practices and Strategies for the Improvement of ESG

Hiro Mizuno
Executive Managing Director & Chief Investment Officer, Government Pension Investment Fund

In 2015, Japan's Government Pension Investment Fund (GPIF) became a signatory to the Principles for Responsible Investment (PRI) advocated by the UN for institutional investors, agreeing to conduct investments that take ESG into consideration. The GPIF is the world's largest pension fund, and its full commitment to incorporating ESG can be considered to have boosted momentum towards ESG investment in Japan in one fell swoop. We began to pay attention to this movement at a global conference about three years ago, where overseas CIOs discussed ESG as a general topic. I felt that our situation was critical, since at that time in Japan, only the "G" element, or corporate governance, was being discussed. We realized that unless this situation changed, it would be unlikely that Japan's stock markets would maintain their appeal for overseas investors.

I would like to emphasize that the GPIF's engagement with ESG investment is not the result of ethical considerations, but rather a consequence of a rational judgment regarding its importance as an investment strategy. The GPIF is a "universal owner", holding stocks and bonds throughout the world, and we own approximately 10% of the shares in the Japanese stock market (after float adjustment). As a result, the success or failure of individual companies is not relevant to us. In addition, because our projected investment horizon is long at 25 years, companies that do not consider the environment or society represent a significant risk as investees. We therefore considered that in order to improve GPIF's investment performance, it would be important to encourage the optimization of the entire socioeconomic system and the reduction of long-term risk factors, thereby raising the level of the market as a whole.

As demonstrated by the long-standing Japanese concept of "*sanpo yoshi*" (benefit to buyer, seller and society), the Japanese worldview has an affinity with ESG principles, but unfortunately Japanese companies have little expertise in the area of disclosure of information. The GPIF has therefore selected a set of ESG indices, and we have requested the index providers to disclose our assessment methodologies. We hope that companies will refer to these methodologies as guidelines to enable them to determine what they should disclose in order to improve their evaluation. Up to the present, fulfilling the duty of communication with investors has been the responsibility of specific departments, but because evaluation now extends to the company's activities as a whole, it is no longer possible to leave the responsibility to others.

As CIO of the GPIF, Mr. Mizuno signed the Principles for Responsible Investment (PRI) in September 2015, and has promoted ESG investment in the fund's portfolio management practice since then. Mr. Mizuno is a graduate of Osaka City University's Faculty of Law. Following graduation, he worked for Sumitomo Trust Bank, Limited (now Sumitomo Mitsui Trust Bank, Limited). He then received an MBA from Northwestern University's Kellogg School of Management. Since 2003, Mr. Mizuno has overseen investment in venture companies and unlisted companies throughout the world as a partner in the London-based private equity firm Coller Capital. He took his present position in January 2015.

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Expert Opinions

# We must not allow ESG to be merely a Fashion, but rather use it to realize Sustainable Corporate Growth

Akiyoshi Oba
Chairman, Japan Investment Advisers Association

The formulation of Japan's Stewardship Code in 2014, providing principles of action for institutional investors, played a significant role in the emergence of ESG investment as a major trend. I was involved in the formulation of the Stewardship Code; the concept of ESG investment was incorporated in the Code, and it positions the role of responsible investors as one of contributing to the realization of sustainable growth. In May 2017, the Code was revised to more clearly state the stipulation that institutional investors should possess an accurate understanding of the companies in which they invest, including ESG.

We must not allow ESG to become merely a fashionable buzzword. To ensure that this does not happen, it will be necessary to consider ESG investment within a broader framework. Why is it that a flow from savings to investments has failed to develop in Japan?  Isn't it a result of the fact that because we have not sought to realize sustainable increases in corporate value, the appeal of investment has failed to increase? What will be necessary in order to change this situation will be for institutional investors to return to the essence of the Stewardship Code – Taking action to encourage the realization of sustainable corporate growth through constructive dialogue. The practice of ESG investment is one method of doing so. Investors must contribute to growth with this type of awareness.

Japanese companies themselves have a long history of ESG-like initiatives, and many companies have long incorporated ESG-like concepts in their corporate philosophies. However, perhaps as a result of the characteristic Japanese reluctance to blow our own trumpet, it is considered that Japan is lagging behind in this area overseas. Indexes have been developed to make it possible to evaluate companies from the ESG perspective, but ESG information is inherently difficult to quantify as data, and to the extent to which these indexes are effective is still unknown. If we over-emphasize formal requirements, we may overlook the essential element, which is the orientation towards sustainable growth.

First, it will be important for corporate top management to ensure that an ESG philosophy, culture and mission take root in their companies. I would encourage management to question their organizations on a daily basis as to what they need to do to remain a company that is necessary to society. And it will also be important for investors to grasp this corporate value that cannot be expressed in figures through dialogue. In both cases there will be considerable difficulty, but these are challenges that are vital to the realization of sustainable corporate growth.

Mr. Oba has long been engaged with the issue of the appropriate direction for the market from the investor's perspective, and contributed to the formulation of Japan's Stewardship Code and Corporate Governance Code as a member of the Council of Experts. A graduate of Waseda University's School of Political Science and Economics, Mr. Oba held positions as a Managing Director of Mizuho Trust & Banking Co., Ltd. and President and Chairman of Tokio Marine Asset Management Co., Ltd.  before taking his present position in 2017. From 2013 to 2017, he served as the Chairman of the Securities Analysts Association of Japan.

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Expert Opinions

# Aiming towards the Achievement of Business Targets integrated with Sustainability Targets

**Tsutomu Igaki**
Executive Officer,
Global Investor &
Brand Communications,
OMRON Corporation

It is vital for all companies and all businesspeople to understand why ESG investment is important, and why it has become a focus of attention. One reason for this is increasing demand on the part of investors for the minimization of risks that might manifest in future. From the perspective of investors, the types of corporate scandals that have occurred quite frequently in Japan and other countries in recent years are events that manifest suddenly. In order to avoid such risks, it will be necessary to reconsider the type of short-termism that evaluates companies based only on short-term business results, and create means of rendering visible companies' intrinsic value, including non-financial data.

The increasing impact of corporate activities on society is another factor. Today, as companies conduct their activities globally, the effect that they have on social issues such as the environment and human rights, and the responsibility that they bear in these areas, have grown to the extent that it is no longer possible to compartmentalize management and social issues. Given this, companies will be required to return sustainable value to society through their business activities over the medium- to long-term, by means of increasing their management transparency and pursuing well-grounded dialogue with the market. At present, approximately 50% of OMRON's shareholders are international institutional investors. We believe that it is essential for us to remain a company that generates exceptional value judged by global standards, and a brand that is the first choice.

Since OMRON's founder defined "To improve lives and contribute to a better society" as our corporate motto, Our Mission, in 1959, OMRON's Principle has been to contribute to society through its business. In 2015, we revised our Principles based on Our Mission, and at the same time formulated our Sustainability Policy with a high degree of compatibility with the UN's SDGs. We have introduced measures to help ensure that all of our employees put the company's principles into practice, and we are making efforts to advance dialogue with our stakeholders by publicizing these initiatives through a variety of media.

We do not, however, believe that we can be neglectful of our financial status under the banner of contributing to society. It is certainly not the case that our financial valuation should compare unfavorably with that of US and European companies because we attempt to benefit society. To realize profits that are not inferior to those of US and European companies by contributing to the development of society through our business is our challenge for the future.

Following his graduation from Waseda University's School of Commerce, Mr. Igaki joined the Mazda Motor Corporation. He later gained experience working for an international consulting firm, after which he served as the Manager of the Public Relations Department of an international consumer goods manufacturer for a period of around 10 years. In February 2013, he joined OMRON as a general manager responsible for overseeing corporate communications. He took up his present position in April 2017. Mr. Igaki is responsible for overseeing the company's IR, SR, PR, internal communications, and brand strategy at the global level. As the Director of the Japan Society for Corporate Communication Studies and the Representative Secretary of the Osaka Machinery Public Relations Council, he is also highly active in extending public relations activities outside the company.

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Expert Opinions

# Financial Institutions must go back to the Basics, honing their Ability to Judge Corporate Potential when Financing

**Keisuke Takegahara**
Executive Officer and Deputy Chief Research Officer, Coordination Department, Development Bank of Japan Inc.

The collapse of Lehman Brothers in 2008 prompted reflection among investors regarding the fact that investment practices had previously been skewed towards an extremely short-term orientation. This reflection increased momentum among investors to recognize that while short-term profits were important, a balance with long-term profits should also be considered. In order to conduct long-term investment, it is necessary to have access to and to evaluate non-financial information regarding the factors that support financial performance below the surface, such as ability to generate innovation, quality of management, and initiatives in the area of corporate social responsibility.

What is required of companies is to establish a logical framework regarding the types of social problems that the growth of their business can address, and to explain this framework to investors. The delineation by a company of its own corporate logic and the presentation of this logic as a value creation message promotes high-quality dialogue between the company and investors. Dialogue also opens up opportunities for growth for the company. Previously, thinking of this type was regarded as ethically sound but costly and unprofitable, but more recently, such thinking has come to be recognized as rational in relation to investment-related activity, among investors no less than among academics.

In the case of indirect financing, once a loan is made, long-term business relations are a given. Because of this, careful consideration of non-financial evaluations of the company that will receive the funds should be considered perfectly natural. From this perspective, ESG investment is quite consonant with indirect financing. In offering loans on the basis of assessment-based certification, the DBJ seeks to understand corporate potential that cannot be judged based on financial data. In order to do so, the responsible member of staff gains extensive access to the company's information under a confidentiality contract, and checks more than 120 items. While this requires effort, this type of evaluation of business potential makes it possible to identify companies that possess strength in terms of non-financial value. By contrast with the ability of investors to evaluate a large number of companies when directly financing, in the case of indirect financing, i.e., face-to-face transactions, the number of companies is limited and the impact is presumably lower. However, while investors engaging in direct investment are able to evaluate large numbers of companies using published data, indirect financing enables deeper judgments that also take in unpublished data. It will also be important to establish cooperation and build a relationship of trust between direct and indirect, making use of the detailed, ground-level evaluations of indirect financing in decisions on investments made by investors using a "bird's-eye view" approach.

Involved in the areas of the environment and CSR for more than 20 years, Mr. Takegahara is a leading Japanese environmental finance specialist and an architect of the DBJ's Environmentally Rated Loan Program. Following his graduation from Hitotsubashi University's Faculty of Law, Mr. Takegahara joined the Japan Development Bank (now the Development Bank of Japan). He took his present position in July 2017, following positions including Chief Representative of the bank's Frankfurt Overseas Representative Office and Director of the Environment and CSR Department. Mr. Takegahara has also served in a number of public positions, including as Co-Chairman of the Steering Committee of the Ministry of the Environment's Principles for Financial Action for the 21st Century and a member of the Ministry of the Environment's Working Group on Incorporating Issues regarding Sustainability into Investment. He has written extensively on the subject of environmentally-conscious financing.

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Expert Opinions

# We should discuss the Essence of ESG investment in order to Reconceive Management

**Rintaro Tamaki**
President, Japan Center for International Finance (Former Deputy Secretary-General, OECD)

The Organisation for Economic Cooperation and Development (OECD) formulated its Guidelines for Multinational Enterprises 41 years ago, in 1976. These offered guidelines for the activities of companies in contemporary society. Incorporating themes including employment, human rights and environmental awareness, they could be considered to be the beginning of the "ESG approach." Since the publication of the Guidelines, the OECD has continued to explore individual related issues with a range of concerned parties in a variety of committees, forums and other venues.

Attention has been focused on ESG investment recently, but we have still not reached a point at which understandings of the essentials of ESG investment are aligned. For example, it has long been a point of contention as to whether elements of ESG other than those relating to immediate profits can be reconciled with fiduciary duty. Investors seeking short-term profits are not interested in the behavior of the companies they invest in, and the financial institutions working on behalf of the investors have an obligation to focus on the pursuit of financial profit in order to respond to the trust of their investors – this has been the traditional way of thinking. This way of thinking has been considerably transformed on a global scale, and a shared consensus is forming that the incorporation of ESG within an investment strategy does not violate fiduciary duty. Having said which, determining how to balance this approach with the pursuit of profit remains difficult, and discussion of this issue continues unabated.

In the sense that it encompasses activities that are not represented on financial statements, for companies ESG can be considered to be close to CSR. In Japan, CSR tends to be understood as an aspect of a company's PR activities, but in essence it should form part of a business strategy based on non-financial data. For example, if a boycott campaign were to arise over child labor, this would represent a risk.The transition to a business model that considers social impact would create the opportunity for future profit. It will be essential for companies to rethink their business models and adequately discuss the issues to be addressed. I was surprised on my return to Japan to discover that there was a tendency to shy away from discussion of topics such as economic disparities (in particular, child poverty), gender and climate change. I believe that it will be important for society as a whole, not merely companies, to engage in discussion on these ESG-related issues. In the absence of such discussion, there is every likelihood that the current interest in ESG investment will be largely without meaning.

Boasting a broad range of experience, Mr. Tamaki is an expert in areas including international economics, development and taxation. Following graduation from The University of Tokyo's Faculty of Law, he joined the Ministry of Finance. Mr. Tamaki held positions as the Alternate Executive Director for Japan with the World Bank, Finance Minister at the Embassy of Japan in the United States of America, and Director-General of the International Bureau and Vice Minister for International Affairs at the Ministry of Finance, before being appointed the Deputy Secretary General of the OECD 2011, where his portfolio included overseeing OECD policy in the areas of the environment, green growth, taxation, financial and enterprise affairs, and anti-corruption measures. He took his present position in October 2017.

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