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Establishing International Rules for Sustainable Finance

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In this paper I will discuss the purpose of a policy proposal that I have been leading to formulate as the Head of the Treasury and Finance Policy Unit of the Liberal Democratic Party (LDP) together with the members of the unit. The background of the proposal is as follows: (1) after the collapse of Lehman Brothers, there has been criticism and reflection on the short-termism, so-called "Quarterly Capitalism", mainly in Europe, UK and the United States; and (2) since 2015, there has been a growing sense of crisis that the "physical risks" and "transition risks" associated with climate change in particular will have an catastrophic impact on the business continuity of corporate and financial/economic stability, and discussions on the regulation have progressed internationally at venues such as G20, Task Force on Climate-related Financial Disclosures (TCFD). In Japan, Prime Minister Suga declared in October that Japan would aim to become carbon neutral by 2050. In the United States, with the inauguration of the Biden administration, this trend has been accelerating.

Under these circumstances, the purpose of this proposal is to logically restructure the “capitalism”, which has been too biased toward short-term profits, into one based on long-term profits. Of course, it is true that there are many short-term investors, but the reality is that institutional investors, especially huge asset owners such as pension funds that have no choice but to invest for the long term, are moving toward a trend based on such long-term returns. In this case, long-term investors should be concerned about the future performance of the companies they invest in, but the traditional financial disclosure to date is, so to speak, data on past performance. Non-financial reporting bridges the gap between past and future performance, and there has been a trend of discussion that disclosure of this information is one of the keys. In addition, since indirect finance plays a major role in Japan, we need a framework that focuses on financial institutions. By developing such a framework, it is important to create a virtuous cycle that will realize economic resilience and long-term stability.

There has been a variety of discussions in the field of sustainable finance or Environmental, Social, and Corporate Governance (ESG) over the years. However, this year, in particular, Mark Carney, the former Governor of the Bank of England, who has led this series of events, became an advisor to the United Nations and the Prime Minister of the United Kingdom; The UK and European nations are chairing international conferences such as the G7, G20, and COP26; The International Financial Reporting Standards (IFRS) Foundation has begun discussions on converging the Non-financial reporting practices of companies that have been scattered so far. Hence, this is an extremely important year for the rule-making process of such regulations. It could be Japan's final opportunity to dedicate our lessons in the formation of international rules, as it has been conspicuously late in getting involved in rule-making so far.

In order for Japan to be actively involved in the international rule-making process, it is important that a solid ecosystem is established in Japan. With this in mind, the Treasury and Finance Policy Unit in LDP, of which I am the Head, has been preparing to submit its recommendations to the government and handed our proposal to PM Suga and DPM, Aso PM. Specific items of the proposal include the following seven points.

(1) Regarding the Non-financial reporting, the proposal states, “It is desirable to include sustainability disclosure in the Corporate Governance Code, which is scheduled to be revised this year. Specifically, disclosure on climate change should be based on the TCFD or standards to be developed by the IFRS Foundation in the coming days should be included.” As a future direction, the recommendation also states, “Further consideration may be given to how it should be done, including a legal disclosure,” and mentions the possibility of listing requirements of exchanges and legal methods.

(2) Regarding the content of disclosure, the proposal states, “For the time being, it is realistic to take “Climate first” approach.” However, it also insists that it is necessary to consider other ESG factors including the “new ‘S’ such as international legal risks related to human rights.” This is because, for example, one may lose market access in the U.S. and other countries if the supply chains include companies related to human rights oppression as in Uyghur and/or Hong Kong.

(3) In addition to recommending the promotion of ESG investment to asset owners such as corporate pension funds, the government should require public pension funds and financial institutions in which the government directly or indirectly holds shares to make a commitment to ESG investment. At the same time, institutional investors who actually manage ESG investments are also required to disclose information on sustainability considerations in their investments.

(4) The proposal also calls for organizing ESG rating agencies to improve the transparency of their evaluation criteria in order to avoid confusion in the market and states the need to develop world-class ESG rating agencies evaluation organizations that are well aware of the situation in Japan and Asia.

(5) In its inspection and supervision of financial institutions or stress tests, the proposal urges the Financial Services Agency (FSA) to “work with the Bank of Japan to promote dialogue with major financial institutions so that they can start scenario analysis by this summer, and to present its approach to monitoring the climate change risk management of financial institutions by the end of FY 2021.”

(6) The proposal also calls on the Bank of Japan to establish a monitoring method for financial institutions similar to that of the FSA, and to consider whether it can expand the scope of asset purchases in its monetary policy, given that the green Quantitative Easing (QE) is being discussed in many countries and the recognition of climate change risks to the financial economy or the prudence policy is being shared.

(7) The Ministry of Finance is also requested to conduct a study on green government bonds; the FSA is requested to steadily develop practical guidelines for social bonds; and the government is requested to set out long-term policies such as carbon pricing and energy mix in a way that is predictable to market participants in the long term.

Taking these points into consideration, at the end, the proposal calls for Japanese government to strategically engage in international rule-making by constructing its own logical framework. Since the US, the UK, and the EU are already start their study on it, if we fail to start our preparation now, we may end up competing under rules created by others without Japanese companies being properly evaluated. That certainly should be the nightmare that Japanese companies have already experienced in many occasions.

(This is an English translation of an outline of the lecture delivered by SUZUKI Keisuke, Former State Minister for Foreign Affairs, which originally appeared on the e-forum "Hyakka-Somei (Hundred Ducks in Full Voice)" of CEAC on March 29, 2021.)