Provisional Translation

The Expert Panel on Sustainable Finance, FSA

The Third Report
- Enhancing sustainable finance -

June, 2023

Table of Contents

1. Trends in sustainable finance .... - 1 -
2. Progress and challenges in sustainable finance initiatives .... - 6 -
  (1) Enhancing corporate disclosure .... - 6 -
  (2) Capital market functions .... - 8 -
    A) Development of data infrastructure .... - 8 -
    B) Institutional investors (asset owners and asset managers) .... - 10 -
    C) Opportunities for retail investor .... - 12 -
    D) ESG evaluation and data providers .... - 14 -
    E) Carbon credit markets .... - 15 -
  (3) Role of financial institutions .... - 16 -
    A) Risk management including scenario analysis .... - 16 -
    B) Initiatives by financial institutions towards decarbonization .... - 18 -
    C) Expansion of GX Finance in Asia .... - 21 -
  (4) Overarching issues .... - 22 -
    A) Promotion of impact investment; .... - 22 -
    B) Climate change responses in the region .... - 24 -
    C) Discussions and future perspectives on natural capital and biodiversity; .... - 26 -
  (5) Human resource development .... - 27 -
3. Next Step - Towards the Materialization of Sustainable Finance .... - 32 -

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（As of June, 2023）

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1. Trends in sustainable finance

With the adoption of the Sustainable Development Goals (SDGs) and the Paris Agreement, constructing a sustainable society is a major challenge. It is now essential to promote sustainable finance, which encourages transition to new industrial and social structures and realizes a sustainable society.

Based on this recognition, the FSA's Expert Panel on Sustainable Finance (hereinafter, the Expert Panel), which was established in December 2020, has been held 17 times to date, and compiled and published two reports (hereinafter, the Reports) in June 2021 and 2022.

From the viewpoint of promoting sustainable finance as a policy, this report has three pillars: enhancement of corporate disclosure, capital market functions, the financial institutions and risk management, and encompasses overarching issues such as promotion of impact investment and skilled professionals. The report has also made recommendations on efforts by related parties and government.

With regard to corporate disclosure, a new section for sustainability information has been added to Annual Securities Reports, and mandatory disclosure on corporate sustainability has started from the fiscal year ending March 31, 2023. Internationally, disclosure standards by the ISSB[1] and guarantee standards by the IAASB[2] are under way. With regard to capital market functions, as the balance of ESG related investments continued to expand, the supervisory guidelines were revised regarding to ESG investment funds, and Code of Conduct for ESG evaluation and data providers was finalized. Various measures have been taken to ensure market soundness and thus stable increase in sustainable finance, coordinating and linking with other countries. With regard to the functioning of financial institutions, engagement between financial institutions and their clients is entering a practical stage, as the real industry's efforts toward emissions net zero are accelerating.

The Japanese Government has made clear that realizing of sustainable growth opportunities through addressing social issues is a key issue element in the "New Capitalism" it advocates and that it should promote corresponding policy measures including sustainable finance. "The Grand Design and Action Plan for New Capitalism 2023 Revision" [3] and the "Basic Policies for Economic and Fiscal Management and Reform 2023," [4] both of which were decided by the Cabinet in June, advocate Green Transformation (GX) investments and loans in Japan and Asia, as well as promotion of impact investment.

With regard to the GX, the Basic Policy on Green Transformation were formulated in February 2023. In order to realize more than 150 trillion yen in GX investment in public and private sectors over the next 10 years, the Government will provide support of upfront 20 trillion yen by issuance of a new sovereign bond for financing GX investment. In addition, the Government will encourage early investment by introducing carbon levy on fossil fuel importers, etc. in fiscal 2028 and auctions for emission allowances from fiscal

1 International Sustainability Standards Board
2 International Auditing and Assurance Standards Board
3 https://www.cas.go.jp/jp/seisaku/atarashii_sihonsyugi/pdf/ap2023.pdf [available only in Japanese]
4 https://www5.cao.go.jp/keizai-shimon/kaigi/cabinet/honebuto/2023/2023_basicpolicies_ja.pdf [available only in Japanese]

2033 (Growth-Oriented Carbon Pricing).[5]

In October 2022, the G20 released the G20 Report on Sustainable Finance, which outlines a framework for transition finance and principles for enhancing the credibility of financial institutions' net zero commitments. The G20 also discussed blended finance, carbon credit transactions, and data collection as important aspects of finance for achieving a net zero. In particular, the G20 confirmed that transition finance, in line with keeping a limit of 1.5°C temperature rise within reach, avoiding carbon lock-ins and based on effective emissions reduction, is important for decarbonization of the overall economy. In October last year, the G20 released the "2022 G20 Sustainable Finance Report," [6] which outlines principles related to a framework for transition finance and enhancing the credibility of commitments by Financial institutions toward net zero. At COP27[7] held in Egypt in November last year, the importance of joint efforts by developing and developed countries to address climate change and the need for a just transition[8] that takes into account changes in the labor environment, markets, and other factors were pointed out. In addition, the importance of finance to realize the transition toward net-zero emissions was discussed, including blended finance,[9] carbon credit trading, and data development.

Since the previous report was published, there have been various actions that, could be seen as a back lash. In the U.S., for example, some local governments have decided not to entrust the management of their employee pension funds to an asset management company that they believe arbitrarily takes ESG factors into its investment decision, which they believe it would exceed the scope of its fiduciary duty from beneficiaries. Also some financial institutions have announced that they resign from a net zero alliance[10] for governance.

On the other hand, financial institutions announcing their resignation from the alliance remain committed to achieving net zero emissions for their own investments and loans and continue dialogue with their clients. In addition, there would be fewer major criticism against taking ESG-related factors into account from the viewpoint of securing investment returns and managing risks. In principle, further progress will be made on major initiatives to strengthen the economic and social infrastructure through financial support for decarbonization and other initiatives.

Sustainable finance initiatives in Japan are making steady progress. For each of the measures discussed in the Initial Report in 2021, substantial progress has been made on the institutional development that was initially envisioned. At that time, the FSA needs to ensure and improve the effectiveness of the aims of the measures and elevate and deepen them into concrete initiatives on the basis of the systems and frameworks developed so far.

5 Cabinet decision on February 10, 2023 https://www.cas.go.jp/jp/seisaku/gx_jikkou_kaigi/pdf/kihon.pdf [available only in Japanese]

6 https://g20sfwg.org/wp-content/uploads/2022/10/2022-G20-Sustainable-Finance-Report-2.pdf

7 27th Conference of the Parties to the United Nations Framework Convention on Climate Change (held in November 2022)

8 The Sharm el-Sheikh Implementation Plan sets out the establishment of a work program on a fair transition and the holding of annual ministerial meetings as part of the work program.

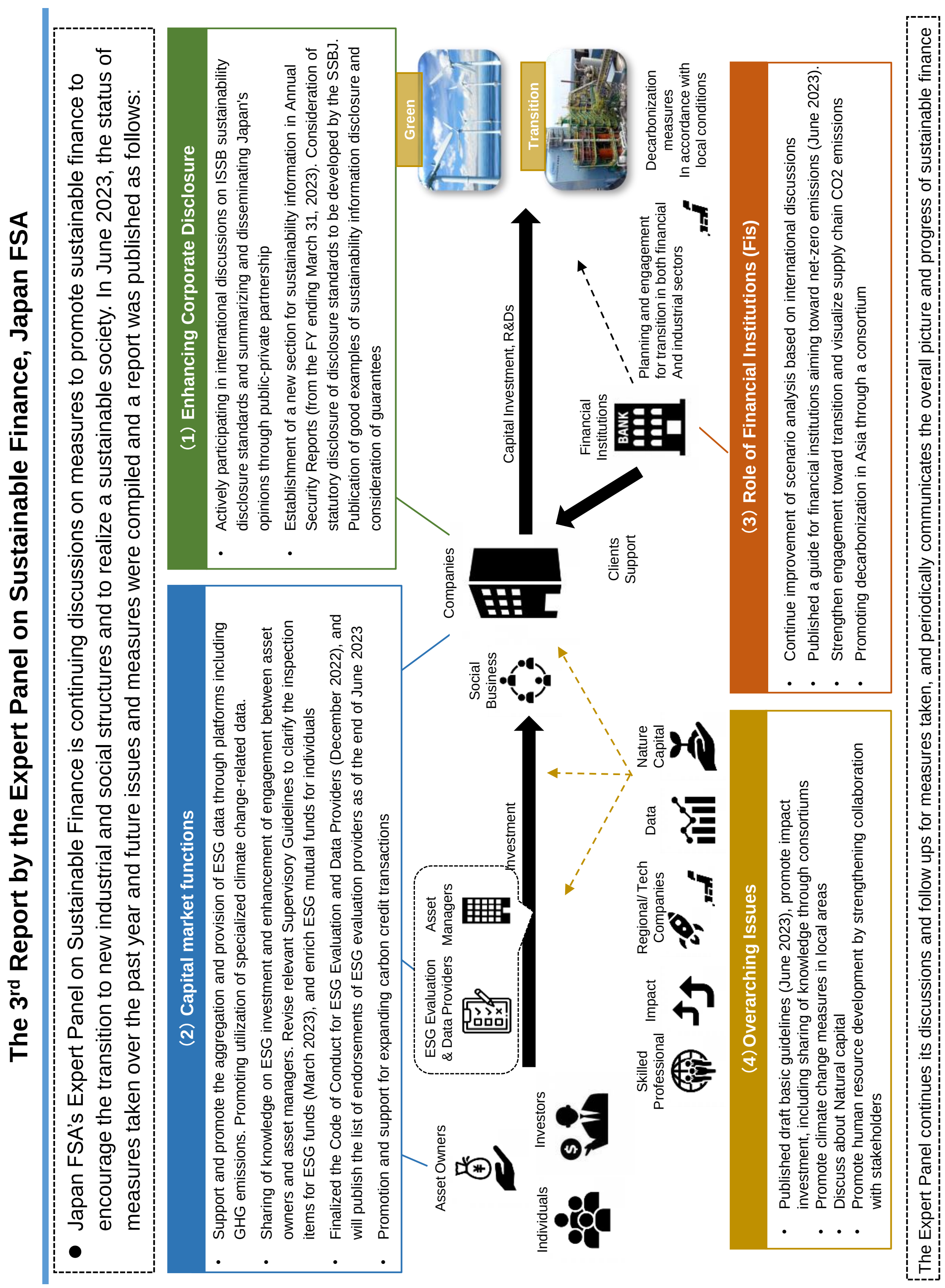
9 A mechanism to provide funds by combining multiple funds with different risk / return preferences, such as private funds and public funds, in fields such as development finance and impact investment

10 Glasgow Financial Alliance for Net Zero (GFANZ)

It is important for the FSA to further expand and deepen various measures to encourage the transition from the financial sector to a new industrial and social structure and to secure sustainable economic and social infrastructure. In consideration of this background, this report was compiled as the Third Report of the Expert Panel. Specifically, while maintaining the main pillars of the policy measures, the Expert Panel summarized the changes in the environment over the past year, the trends and update of policy measures. It also assessed new and recognized issues, and summarized the overall picture on direction of the policies.

These sustainable finance initiatives are summarized as shown in the figure below. The FSA will update and disseminate the overall progress in its roadmap in a timely manner on the FSA's website and other media.

(Figure 1) Overview of sustainable finance initiatives



(Figure 2) Roadmap for sustainable finance initiatives

2. Progress and challenges in sustainable finance initiatives

(1) Enhancing corporate disclosure

- Need to actively participate in discussions on international standards and promote efforts to enhance disclosure -

The Initial Report states that issues related to economic and social sustainability can create various risks and opportunities in business activities, and that it is important for companies to have dialogues with various stakeholders, such as investors, financial institutions, business partners, and workers. As a prerequisite for these dialogues, the enhancement of corporate disclosure would continue to be a key driver.

The FSA amended the Cabinet Office Ordinance in January of this year based on a proposal from the Working Group on Corporate Disclosure of the Financial System Council published in June 2022 to establish a separate section in Annual Securities Reports to provide sustainability information in an integrated manner.

The section for "Concept and Initiatives on Sustainability," which was newly added to the Annual Securities Report as a result of the revision, requires companies to disclose their views and initiatives on sustainability based on the four components of governance, strategies, risk management, and metrics and targets in a way that is consistent with international frameworks such as the TCFD[11] and the International Sustainability Standards Board (ISSB). The revision also requires the disclosure of indicators such as the ratio of women in managerial positions and human capital, including diversity of human resources.

Internationally, the ISSB established by the IFRS Foundation in November 2021, published in March 2022 draft "General Requirements for Disclosure of Sustainability-related Financial Information " (Standard S1) and "Climate-related Disclosures" (Standard S2) as the first topics of a proposed global sustainability disclosure standard. Both standards were finalized in June 2023 based on the results of consultations conducted up to July 2022. Furthermore, in May 2023, the ISSB launched a call for comments on its two year standards development priority agenda starting in 2024, with candidates including human capital and biodiversity. The G7 Hiroshima Summit and the G7 Minister of Finance and Central Bank Governors Meeting in Niigata also expressed their support and expectations for the ISSB's current and future efforts.[12]

In addition, the International Auditing and Assurance Standards Board (IAASB), which maintains international auditing standards, approved and published a project last September to develop international standards for assurance practices on the reliability of sustainability information,[13] which are implemented by various entities including audit firms, ESG evaluation providers, and ISO certification bodies. The exposure draft of the new standards was approved in June 2023 and will be finalized in September 2024. The

11 The TCFD (Taskforce on Climate-related Financial Disclosures) has proposed a framework for identifying and disclosing companies' climate-related financial information in four key areas: governance, strategies, risk management, and metrics and targets. This framework is consistent with ISSB's disclosure standards.

12 Statements from the G7 Hiroshima Summit and Minister of Finance Governors supported ISSB's "finalizing the standards for general reporting on sustainability and for climate-related disclosures and working toward achieving globally interoperable sustainability disclosure frameworks" and looked forward to "future work on disclosure on biodiversity and human capital."

13 It means that an independent third party represents in its conclusions the results of the verification work carried out in order to increase the degree of confidence of the assumed users of the information.

International Ethics Standards Board for Accountants (IESBA) is also developing ethics and independence standards for sustainability reporting and assurance.

The Sustainability Standards Board of Japan (SSBJ), [14] established in July 2022, takes on central role in these international discussions. And Japanese public and private sector stakeholders are actively providing opinions while working together.[15] For instance, the industry-specific requirements for S2 standards were initially non-binding examples. This means both investors and companies are contributing to the formulation of standards that are easy to work with and use.

The Report of the Disclosure Working Group published in December 2022 presents a roadmap for Sustainability Disclosure in order to increase predictability for companies and investors and make practical preparations, while taking into account international discussions such as those in the ISSB and the IAASB, as to what kind of measures and schedules would be considered as initiatives for enhancing sustainability disclosure in Japan.

In order to enhance sustainability disclosure, the roadmap indicates that the SSBJ is considering disclosure standards, taking into account the actual conditions of investors and companies in Japan. Going forward, while clarifying the legal position of the SSBJ in laws and regulations, the FSA will incorporate the disclosure standards it plans to establish into statutory disclosure. Regarding assurance services, the FSA will discuss the establishment of disclosure standards, who should provide assurance services, the standards, scope, and levels related to assurance, and the legal or institutional framework, based on trends in Japan and overseas.

(Future issues and direction of measures)

The ISSB's discussion of international sustainability disclosure standards is making rapid progress. Japan has already made active contributions to related parties in terms of both human and financial resources, including support for the Tokyo office of the IFRS Foundation. In addition, both the public and private sectors should continue to contribute and actively disseminate opinions. Furthermore, the FSA also needs to pay attention to international trends with regard to assurance standards and the independence standards on those involved in assurance services, and to continue discussions with assurance service providers, companies and investors.

At the same time, the SSBJ will develop domestic standards and the FSA incorporate the developed standards into the statutory disclosure. In addition for enhancing sustainability disclosure, the FSA and other bodies will collect and publish good practices on disclosure and develop human resources.

Furthermore, with regard to Scope3 emissions data that is of great interest to the market, the relevant ministries and agencies would better cooperate to support data development efforts by private businesses, so that the disclosed data would widely and effectively be utilized. Therefore, as described in (2) below, the FSA needs to provide

14 Last November, the SSBJ published an Operating Policy setting out its basic policies regarding activities related to the development of sustainability disclosure standards and activities related to contributing to the development of international sustainability disclosure standards. In addition, in February of the year, the SSBJ published "Future Plans for Sustainability Disclosure Standards Currently Under Development," with the goal of finalizing the Japanese S1 and S2 standards by the end of March 2025

15 Private organizations such as the Securities Analysts Association of Japan and the Japan Business Federation are conducting studies and disseminating opinions ISSB.

information in a form that facilitates data utilization, and to aggregate and provide the disclosed information together with various data in engagement with investors.

(2) Capital market functions

A) Development of data infrastructure

- Need to consolidate ESG data and ensure quality under international collaboration -

The Initial Report pointed out that compared to general equity and bond investment, ESG information that goes beyond transaction information such is necessary in the field of sustainable finance. The report also pointed out that the consolidation of ESG investment information and ensuring eligibility are important challenges for the development of infrastructure for the effective functioning of the market.

The Sustainable Finance Platform Development Working Group, which was set by JPX (Japan Exchange Group), complied interim report[16] to enhance the ESG market and ensure transparency in January 2022. In this interim report, JPX announced to establish an "ESG Bond Information Platform" to aggregate bond issuance information, issuers' ESG strategies, information on external evaluations, reporting information including impacts, and other information. The platform was launched in July 2022.

The bond information on the platform is updated in a timely manner with the cooperation of securities companies. In addition, the platform lists second-party opinions and evaluation standards that investors had to check by themselves in the past. The platform would be an important infrastructure due to the ease of information access and the number of views.

In terms of data related to ESG investment, there is a growing need and interest the consolidation of corporate sustainability data, including GHG emissions data. This is due to the progress in the development of frameworks for sustainability disclosure, including climate change, in Japan and overseas,

For example, the above-mentioned Interim Report points out that the need for corporate's ESG-related data is increasing rapidly as companies expand their disclosure, and that it will be an important issue in the future to aggregate and present data in an easy-to-understand manner through platforms and other functions.

Turning to international trends, the Climate Data Steering Committee, established in June 2022 by French President Emmanuel Macron and UN Special Envoy for Climate Ambition and Solutions Michael R. Bloomberg, released a recommendations for development of a Net-Zero Public Utility (NZDPU).[17] NZDPU will centralize and provide data such as typical global corporate emissions (scope 1, 2, and 3), financed emissions from financial institutions, and the use of carbon credits by companies.

The committee aims to achieve certain outcomes by COP28, including the mapping of data in terms of consistency, comparability and availability, and the launch of a pilot version. Climate change-related data need to be widely and easily available, which will increase market transparency and enable companies, financial institutions to assess their efforts and progress in this way.

With regard to estimation data, differences could exist between data providers. In this regard, the "Code of Conduct for ESG Evaluation and Data Providers" formulated and published by the FSA in December 2022 (see (2) (d)) states that:

16 https://www.jpx.co.jp/news/0090/nlsgeu0000065amd-att/JPXSFPlatformDevelopmentWGFirstReport.pdf

17 https://www.nzdpu.com/

- ESG data includes both original data disclosed by companies and estimated data created by data providers, both of which are widely used and highly important in investment judgment and evaluation. In particular, estimated data has various impacts if there are errors in the process of estimating and using it, even though companies do not create it themselves.
- Regarding GHG emissions, there are particularly large differences between data providers for Scope 3 emissions.

In addition, ESG evaluation providers are required to disclose the source of information on which the evaluation is based, and in particular, when using estimated data, to disclose the basic method of estimation.

(Future issues and direction of measures)

In order to develop market infrastructure for sustainable finance, it remains important to consolidate various ESG information and ensure its quality. In particular, with regard to corporate data, there are challenges to sort out the original data disclosed by companies and estimated data, ensure transparency in data calculation methods, and improve governance of data providers. The FSA is planned to summarize the status of endorsement as of the end of June 2024 for data providers in the above Code of Conduct.

Within the diverse data, scope 3 emissions data needs to be calculated for all upstream and downstream business partners of companies, such as supply chains. Therefore, relevant ministries and agencies should cooperate and support the efforts of private businesses to develop the data.[18]

The corporate disclosure data should be used as the basis for ESG investment in Japan, while promoting the development and quality of ESG data. To this purpose, the FSA will provide information and data using tools such as XBRL, and there is a need to consolidate and provide data progressively in combination with various other data through the JPX platform and other functions.

Furthermore, JPX has issued a "Green Digital Track Bond" that uses security tokens to make green indicator, which is the amount of power generated by renewable energy power generation projects, visible in a timely manner. In the future, JPX is expected that data related to this bond will also be made available on, for example, the ESG Bond Information Platform.

In order to effectively and efficiently implement Japan's initiatives related to data, Japanese public and private sector actors are expected to work with international data development and collaboration initiatives, including NZDPU, as necessary, and actively contributing to international data development initiatives. In this context, collaboration with data development efforts in Asia, taking into account GX trends, is also possible.

In terms of utilization of data on business, companies need to use a range of natural, social and business data to understand the impacts that vary from company to company, and to formulate strategies based on such impacts. For example, company's business could be affected by both risks and opportunities due to temperature increases and climate changes and how to adapt to it.

From this perspective, in collaboration with relevant ministries and agencies and

18 Understanding supply chains is also becoming increasingly important from the perspective of human rights and other sustainable finance.

private businesses, discussions are taking place to encourage the appropriate use of specialized climate change-related data accumulated in a wide range of fields. The public sector and private sector that provide climate related data, as well as companies and financial institutions need to engage in more dialogue and cooperation with utilization of data (see "Reference" below).

(Reference) Promoting the use of data related to climate change

Private financial institutions and companies could appropriately use specialized climate change-related data (including scenario data) accumulated over a wide range of fields. They would be able to reliably and objectively assess and analyze climate related risks and opportunities, and effectively implement measures against climate change, including corporate disclosure and dialogues with customers.

However, data related to climate change often requires expert knowledge including the characteristics of figures and estimates, making it difficult for private financial institutions and companies to utilize data. Therefore it would be important for financial institutions and companies to have a practical knowledge on how the data can be used for risk and opportunity analysis and strategic planning for the business by understanding the characteristics of the data and combining them appropriately.

In December 2022, the FSA, MEXT (Ministry of Education, Culture, Sports, Science and Technology), MLIT (Ministry of Land, Infrastructure, Transport and Tourism), and MOE (Ministry of the Environment) co-hosted the Advisory Council on Scenario Data for Climate Change Risks and Opportunity Assessment. In order to encourage the effective provision and utilization of climate change-related data and to create an environment that generates sustainable innovation using data, a wide range of stakeholders including research institutions, business corporations, and financial institutions, discussed the needs and challenge of data utilization and the direction of measures. In June 2023, a summary of the discussions and a list of climate change-related data being developed by the government were published. Going forward, the Advisory Council will continue to engage in interactive discussions on topics such as sharing ideas and issues related to scenario analysis and assessment of risks and opportunities, while keeping a close eye on the flow from data collection to business judgment, and the relevant ministries and agencies will consider and implement the necessary measures.

B) Institutional investors (asset owners and asset managers)

- Need to build a sustainable investment chain through dialogues among relevant parties -

As pointed out in the previous reports, institutional investors are expected to play an important role in providing necessary funding and other support to companies that are promoting sustainability initiatives from a medium- to long-term perspective, and in encouraging to increase their corporate value through stewardship activities.

This could lead to an increase in medium- to long-term investment returns for institutional investors' clients and beneficiaries. In other words, of institutional investors deepening their engagement with companies on sustainability issues, and individual companies become more strategic in areas where impacts are emerging, economic and social infrastructure and long standing investment profitability would be strengthened.

As pointed out in the Initial Report, with regard to institutional investors' approaches to responsible investment, the PRI[19] requires investors to consider ESG-factors in their investment decision-making process to the extent that it does not conflict with the fiduciary duty of each investor, and thus plays an important role in the promotion of ESG investments. The number of signatories to the PRI has more than doubled in the past five years, and the number of investors have signed up to the Japanese Stewardship Code, has increased to 324 as of the end of April 2023. With the start of disclosure regulations based on the TCFD framework for TSE (Tokyo Stock Exchange) Prime Market listed companies fiscal year 2022, and the progress on disclosure framework at the ISSB and the Financial System Council (see 2 (1)), there are investors to further clarify their policies for engagement with companies, including ESG-strategies. With regard to climate changes, some Japanese financial institutions are participating in international initiatives by institutional investors aimed at achieving net zero.[20]

On the other hand, looking at the actual situation of ESG investment by institutional investors, there seem to be still challenges for both asset owners and asset managers.

Asset owners include various entities, such as life insurers, public pension funds, and corporate pension funds, depending on the characteristics of the beneficiaries and underlying contracts and assets. Even among asset owners in the same business category, there are different ways of managing assets, depending on their size and other factors, and their investment and engagement strategies and approaches vary accordingly. For example, according to the results of a questionnaire survey[21] conducted by Asset Management One Co., Ltd., introduced in the FSA's Progress Report on Enhancing Asset Management 2023,[22] approximately 10% of corporate pension funds, in terms of number of funds, accept the Stewardship Code, but approximately 80% have no plans to do so. It is necessary to share knowledge on measures and systems to improve the growth and sustainability of assets under management, including ESG investment, based on the asset size and basic approach of each investors.

The initiatives of asset managers entrusted with asset management are important in order for asset owners to increase the growth and sustainability of their assets through ESG investment. From the aspect of asset managers, a sustained increase in assets of asset owners, who are their clients, leads to stable growth in their own earnings through an increase in management fees.

For example, with regard to "impact investment" described below, some asset managers are driving forces in Europe and the United States as market interest is on the rise, but efforts still needed in Japan. In general, even if asset owners are interested in these new areas of investment, it is not easy to invest without asset managers who have a track record and knowledge. And vice versa, it is difficult for asset managers to build a track record without entrustment from asset owners, and without a track record, they would be less likely to receive the entrustments. In the United States and Europe, for example, Sovereign Wealth Funds and public financial institutions have introduced initiatives to entrust a certain amount of investment to asset managers who are creative in

19 Principles for Responsible Investment
20 As of April 2023, 5 asset owners (NZAOA) and 11 asset managers (NZAM) have participated from Japan.
21 Conducted from July to August 2022, covering corporate pensions, business corporations, and other corporations
22 https://www.fsa.go.jp/en/news/2023/20230620/20230620.pdf

various ways in order to foster such emerging asset managers.

Regarding issues related to both asset owners and asset managers, the "Action Program for Accelerating Corporate Governance Reform" formulated by the FSA in April 2023 points out challenges in ensuring the effectiveness of engagement, such as expanding the framework, securing resources, and devising engagement methods and providing incentives, with regard to the intrinsic stewardship activities. Promoting autonomous awareness-raising of asset owners and asset managers is expected.

(Future issues and direction of measures)

As could be seen from the signing of the PRI, participation in various initiatives, and the trend of increasing ESG investment, the number of institutional investors who consider sustainability in investment and engagement is steadily increasing. Going forward, the challenges will be to further increase the spread to asset owners, to materialize investment strategies and ensure the effectiveness of engagement. However, the issues vary depending on the asset size and the characteristics of the beneficiaries, and it will be important to take measures that suit the actual situation of each institutional investor. Therefore, the FSA need to share knowledge on measures to increase the growth potential and sustainability of assets under management, including ESG investment, while taking into account the challenges of each institutional investor.

The Government’s “Doubling Asset-based Income Plan” published in November 2022 also points out that, from the perspective of maximizing the benefits to beneficiaries and others, the plan desires to establish a system for continuous dialogue with a wide range of stakeholders to realize appropriate investment returns based on the nature and size of the assets. Discussions among stakeholders, including beneficiaries, asset owners, asset managers and investee companies, are expected to include consideration of sustainability. In addition, at the Council on Economic and Fiscal Policy meeting in April, Prime Minister Kishida announced that the Government of Japan would formulate a policy plan which fundamentally reforms the asset management industry in Japan and from this perspective that the Government would engage in discussions including sustainability.

Finally, the PRI in Person 2023 is scheduled to be held in October this year. Further discussion and promotion would take place as a venue for global and Japanese institutional investors to meet.

C) Opportunities for retail investor

- While strengthening accountability for ESG funds, it is necessary to diversify products and improve explanations -

The Initial Report states that it is important to expand ESG investment opportunities for individual investors in order to link individual financial assets to stable asset formation. In addition, in order to increase the growth potential and sustainability of companies through investment, not only institutional investors but also individual investors should participate in sustainable finance market. The involvement and understanding of diverse stakeholders is also important to enhance this market.

With regard to ESG investments by individuals, usually households generally entrust their assets to asset management companies and invest in funds (e.g. trust funds.) that are managed by the asset management companies by combining investment in multiple companies. On the other hand, it has been a challenge for asset management companies to communicate to individual investors in an easy-to-understand manner the strategies and benefits of ESG investments by selecting multiple companies based on what criteria. Some mutual funds have been accused of greenwashing,[23] where the strategies and names listed do not reflect the actual investment status

In Europe, the Sustainable Finance Disclosure Regulation (SFDR), which has been in force since 2021, requires investment funds to disclose the definition of sustainability and the ratio of investment assets that meet the definition and assets that suit the EU Taxonomy when setting up sustainability funds. Specifically, the SFDR requires investment assets that meet the EU Taxonomy to account for at least 50% of their investment assets when sustainability is advocated.

In the United States, the Securities and Exchange Commission (SEC) has published a proposed rule change. In this proposal, funds are classified based on the extent to which they take ESG factors into account, and are required to disclose depending on the classification, for example, the benefits they intend to achieve in their investments and valuation methods.

The Japan FSA also compiled "Seven Expectations for Asset Management Companies managing ESG Investment Trusts" in the "Progress Report on Enhancing Asset Management Business 2022"[24] published in 2022, and based on this, made necessary revisions to the Comprehensive Supervisory Guidelines for Financial Instruments Business Operators, etc. The revisions, which came into effect at the end of March 2023, set out the scope of ESG-related investment trusts, as well as specific inspection items regarding the disclosure of ESG-related information on publicly offered investment funds and the development of organizational structure by asset management companies.

Looking at the actual state of investment, it has been pointed out that, amid the development of such international regulations, there are some actions to refrain from new establishment and sales of funds for which asset quality and management policies cannot necessarily be sufficiently explained in light of such regulations. It is necessary to understand the recent decline in sales of ESG funds in light of this background. However, even if sales decrease temporarily, the FSA expects that the market will develop soundly in the medium to long term through the clarification of investment and origination policies by investment trust founders.

Regarding investment products offered to individuals, the total amount of ESG investment through mutual funds is low in Japan compared to in Europe and the United States.[25] In addition, looking at assets under management of ESG funds in Japan by investment method, the ratio of passive investing, which tracks the performance of a particular market or index, remains at around 10%,[26] which is lower compared to Europe and the United States.[27] In ESG funds, it is important to conduct engagement by asset managers and others to increase corporate value over the medium to long term.

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23 Making it appear as if the environment is being taken care of, even though this is not accompanied by an environmental improvement effect.

24 https://www.fsa.go.jp/en/news/2022/20220527/20220527_3.pdf

25 Funds and ETFs that name sustainability, impact, ESG, etc. or that focus on investment policies in Morningstar "Global Sustainable Fund Flows: Q4 2022 in Review" are aggregated. Passive refers to funds and ETFs that advocate passive strategies regardless of the type of index.

26 Compiled based on data from QUICK for funds and ETFs under the titles of ESG, SRI, CSR, environment, and corporate governance.

27 Passive investment accounts for more than 50% of all investment trusts in Japan

This requires certain costs including human resources. On the other hand, it is also important to hold down investment costs from the viewpoint of encouraging a wide range of individual investors to participate in the market for a long term and build assets.

Asset management companies need to develop investment products with high appeal and clear investment strategies, including engagement as an ESG funds that make it easier for individuals to invest and contribute to corporate growth.

(Future issues and direction of measures)

The SFDR requires investment funds to classify their fund either "sustainable investment" or not. In addition it requires all financial market participants offering financial products to assess and report their portfolio alignment with the EU Taxonomy.

Regarding ESG funds in Japan, it is reasonable to regulate and supervise fund management companies to disclose specific sustainability information by themselves. The information includes how ESG evaluation in used in the investment decisions.

It is important not only to disclose information in funds but also to expand investment opportunities for individual investors. For that, it is necessary to provide individuals with a concrete understanding of the benefits of investing. Financial institutions are required to devise ways to communicate the points in an easy-to-understand manner, for example, they can learn about the sustainability initiatives of the companies they invest in, and long-term company growth will lead to investment returns.

For example, it is meaningful to diversify and penetrate ESG-related products, such as passive ESG funds, ex-Japan investment funds that contribute to the Asian GX, and green bonds issued by Asian issuers. In addition, the new NISA (Nippon Individual Savings Account) will be launched in January 2024, as its annual non-taxable investment quota significantly expanded. Experts suggest that this could be an opportunity to promote ESG investment in combination with financial and economic education.

D) ESG evaluation and data providers

- Need to improve services through penetration of the "Code of Conduct" -

ESG evaluation and data providers play an important role in evaluating the status of ESG initiatives of various companies, including their use in indices used in investment trusts, and in evaluating ESG eligibility for investments products.

For example, evaluation providers evaluate companies in each of the areas of environmental, social, and governance perspective based on their own evaluation standards, and create an index based on the results of overall evaluation. Institutional investors sometimes make investment decisions based on this index, other evaluation providers evaluate the suitability of individual financial products, such as bonds, considering international standards, and institutional investors invest based on this evaluation. While evaluation methods and the use of evaluations vary depending on the entity or target, the role of ESG evaluation and data providers that evaluate companies' ESG initiatives is increasing.

In order to ensure the transparency and objectivity of ESG-related evaluation on various social and environmental issues, the FSA established the Technical Committee for ESG Evaluation and Data Providers under the Expert Panel. Based on the Technical

Committee's report in July 2022, the FSA formulated the Code of Conduct for ESG Evaluation and Data Providers in December 2022. The Code of Conduct requests, as voluntary code, ESG evaluation and data providers in the Japanese market to accept and disclose their endorsement of the Code, which includes items such as ensuring the quality of evaluation, engaging with investors and companies, and ensuring the independence of evaluation. The FSA will publish the list of endorsement regarding ESG evaluation as of the end of June 2023, and regarding ESG data as of the end of June 2024.

(Future issues and direction of measures)

Regarding the Code of Conduct, some domestic and overseas ESG evaluation providers are already expressing their endorsement or direction of endorsement. The FSA is required to ensure the effectiveness of transparency and objectivity of evaluation by disseminating the Code through careful dialogue, including related to the provision of ESG data.

For example, in other areas such as the Corporate Governance Code, efforts are being made to share examples and points of discussion on issues that posed particular challenges in terms of compliance with the Code. The FSA and the above-mentioned Technical Committee need to continue discussions on ways to ensure the effectiveness of this Code of Conduct while interacting with evaluation and data providers in Japan and overseas. In particular, the endorsement of data providers as of June 2024 would be important as there may be practical challenges. Therefore a careful dialogue with data providers is expected.

Furthermore, the Code of Conduct recommends institutional investors, who use ESG evaluation and data, to clarify and disclose the usage of evaluation and data in their investments. It also recommends companies which are evaluated to disclose their ESG initiatives in an easy-to-understand manner. Each of these measures is expected to be taken.

The Code of Conduct also recommends that institutional investors, who are the users of ESG evaluation and data, clarify and disclose how they use the evaluation and data in their investments, and that companies receiving assessments also disclose their ESG initiatives in an easy-to-understand manner.

In addition, the development of their Codes of Conduct is an example of Japan developing a framework relatively earlier than other countries. Therefore the FSA needs to collaborate with other authorities, such as by participating in a public-private working group on codes of conduct in other countries. The public and private sectors should continue to cooperate with other countries to promote and improve, and the FSA will also actively promote other initiatives in the future based on its experience.

E) Carbon credit markets

- Early establishment of carbon credit market and participation of financial institutions -

Interest in carbon credit trading is rapidly increasing as international efforts to achieve decarbonization are accelerated. In Japan, companies participating in the GX League are required to procure carbon credits by around the summer of 2026 for the shortfall in emissions reductions that did not reach the target set by the companies in the first phase (2023 to 2025). After that growth-oriented carbon pricing will be introduced on a trial basis from 2026, and the emission allowance will be made to pay from 2033. In this way the demand for carbon credit trading is expected to increase. Along with this, the supply of J-credits derived from energy and forest conservation is also estimated to increase.

The financial sector is expected to make various contributions. For example, acting an intermediary for the trading of carbon credits generated in Japan and overseas, establishing a trading market for transaction of carbon credits, which are relatively traded over the counter right now, and supporting the efforts of businesses including overseas to generate carbon credits for the purpose of absorbing and reducing greenhouse gas emissions.

The TSE plans to establish a carbon credit market by October 2023 based on a pilot project completed in January 2023, and the FSA revised the interpretation on carbon credit under the Financial Instruments and Exchange Act in December 2022 in order for financial institutions to participate more early in carbon credit transactions.

(Future issues and direction of measures)

In order to expand carbon credit transactions, the Government will continue to take initiatives to develop the transaction market, at the same time developing and promoting actual projects that contribute to carbon absorption and reduction. In addition, the public and private sectors should appropriately ensure quality assurance, such as by ensuring the effectiveness of carbon credits absorption and the consistency with international frameworks, and to improve the soundness and liquidity of the market by encouraging accurate understanding by investors.

For this reason, the public and private sectors are expected to work together to support demand and supply on the financial side through various functions such as the development of carbon credit frameworks, accounting and tax treatment, development of transaction bases, demand development, and market intermediation. In particular, regarding the creation of projects, regional financial institutions need to deepen the knowledge on carbon credit since there are various characteristics of carbon credit, including the presence or absence of public certification.

(3) Role of financial institutions

A) Risk management including scenario analysis

- Japanese and overseas institutions are required to enhance and utilize scenario analysis -

Japan has a high ratio of indirect finance, and compared to other countries, financial institutions play an important role in the relationship with companies. Thus, financial institutions involved in indirect finance are expected play a role in the area of sustainable finance.

In July 2022, the FSA published "Supervisory Guidance on Climate-related Risk Management and Client Engagement."[28] Based on discussions at the Basel Committee on Banking Supervision,[29] the NGFS,[30] and other bodies, the Guidance focuses on the

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28 https://www.fsa.go.jp/en/news/2022/20220715/20220715.html

29 In June 2022, the Basel Committee on Banking Supervision published “Principles for the effective management and supervision of climate-related financial risks” to improve practices related to the management of climate-related financial risks and to provide a common baseline for internationally active banks and authorities.

30 Network for Greening the Financial System

strategy formulation to address climate change, the identification and assessment of risks and opportunities, and the establishment of frameworks for responding to risks by financial institutions as key points for dialogue between the FSA and financial institutions.

In this context, scenario analysis is cited as an effective method for quantitatively assessing risks and opportunities related to climate change. In light of this, the FSA and the Bank of Japan, in cooperation with three major banks and three non-life insurance groups in Japan, conducted a pilot scenario analysis using scenarios published by the NGFS as common scenarios. The results of the analysis and the main issues and challenges were published in August 2022. It is important for financial institutions to continuously improve their analyses so that they can use the analyses to develop their business strategies and support their clients, while addressing the issues related to data and methodologies identified in the exercise.

The FSA will continue to deepen its understanding of climate-related financial risks (transition risks and physical risks) in order to promote effective dialogue with financial institutions. The FSA conducted a pilot analysis of financial institutions' climate-related financial risks[31] using loan data, geographical data and other data collected from financial institutions. The results of the analysis, published in June 2023,[32] indicated that the impacts of climate-related financial risks vary among financial institutions depending on their geographical regions and portfolio characteristics. On the other hand, the analysis also revealed common issues related to data availability and analytical methods. In light of these points, the FSA need to continue to work with financial institutions to develop data and enhance analyses.

As for the management of climate-related financial risks, it is better for financial institutions to consider the necessity of improving the existing risk management framework in accordance with international discussions and the progress of risk management methods and practices. In addition, as for risks that are expected to materialize in the medium to long term, financial institutions need to assess how climate-related financial risks will affect financial risks in each category (credit risk, market risk, liquidity risk, operational risk, etc.,)[33] in the same time frame and respond to them, taking into account their own business characteristics.

In terms of international developments in risk management, for example, the Basel Committee on Banking Supervision published "Principles for the Effective Management and Supervision of Climate-related Financial Risks"[34] in June 2022 to improve both banks' risk management and supervisors' practices related to climate-related financial risks and provide a principle-based approach. In addition, the FSB published "Supervisory and Regulatory Approaches to Climate-related Risks: Final report"[35] in October 2022, providing recommendations to regulators, including the development of

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31 This analysis was conducted by the FSA using loan detail data collected as part of a pilot project to develop a new effective and efficient data collection and management framework (so-called joint data platform) in collaboration with the Bank of Japan.

32 Analysis of climate-related financial risks - https://www.fsa.go.jp/common/about/kaikaku/fsaanalyticalnotes/fan2022_4.pdf [available only in Japanese]

33 Risks associated with FIs are generally classified into credit risk, market risk, liquidity risk, and operational risk. Climate-related risks do not add new risk categories to these. It is a "risk driver" that can increase or decrease the risk of each category through the various pathways described so far, starting with climate change-related changes.

34 https://www.bis.org/bcbs/publ/d532.pdf

35 https://www.fsb.org/2022/10/supervisory-and-regulatory-approaches-to-climate-related-risks-final-report/

common definitions of climate-related data and climate-related financial risks that should be reported and collected for regulatory oversight by focusing on the system-wide aspects of climate-related financial risks.

Central banks' responses to and analysis of climate-related financial risks are also important. In November 2022, the FSB and the NGFS jointly published "Climate Scenario Analysis by Jurisdictions: Initial Findings and Lessons,"[36] which provides an overview of scenarios, models, data and metrics used by 53 institutions in 36 jurisdictions and challenges of climate scenario analysis. The Federal Reserve Board announced its scenario analysis program for climate-related financial risks in January 2023, and the results of the six banks will be published within 2023.[37]

Various transition and physical risk scenario analysis tools exist, and their characteristics are difficult to understand. "The 2023 Climate Risk Landscape,"[38] published by UNEP FI in March 2023, provides a description of the risk analysis framework and a comparative table of tools that can analyze climate-related financial risks. Scenario analysis methods could be improved with referring this kind of information.

(Future issues and direction of measures)

The FSA convinces that the Guidance, which was formulated in July 2022 and organizes the perspectives of financial institutions on climate change, remains effective, even in light of dialogues with foreign authorities, in that it examines risks and opportunities of clients together with their own risks and opportunities, and encourages active engagement.

Going forward, the FSA need to actively participate in international discussions on the development of data and methods for scenario analysis, and deepen discussions with financial institutions on the data, methods, and specific uses of scenario analysis based on international discussions and practical developments.

B) Initiatives by financial institutions towards decarbonization

- Engagement towards net zero and securing eligibility for transition and international communication are important -

Based on the basic concepts described in the Guidance mentioned above, in order to promote effective engagement between financial institutions and client companies towards decarbonization, the Working Group on Financial Institutions' Efforts towards Decarbonization of the Economy was launched under the Expert Panel in October 2022, and the discussions were compiled and published as a report in June 2023.[39]

As a proposal to financial institutions, the report pointed out that in order to achieve decarbonization, medium-to long-term business strategies and capital expenditure based on these strategies are necessary. And in order to appropriately formulate and implement such strategies and capital expenditure, enhancement of engagement between financial institutions and their client is important.

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36 https://www.ngfs.net/en/climate-scenario-analysis-jurisdictions-initial-findings-and-lessons

37 Climate Scenario Analysis by Crises: Initial findings and lessons
https://www.federalreserve.gov/publications/climate-scenario-analysis-exercise-instructions.htm

38 UNEP FI https://www.unepfi.org/themes/climate-change/2023-climate-risk-landscape/

39 https://www.fsa.go.jp/singi/decarbonization/siryou/20230627/03.pdf

Based on the above, the report presents concrete measures to be considered by financial institutions aiming at net-zero through engagement with customers as a recommendation (“Guide”), including (i) how to understand the transition of financial institutions, (ii) developing GHG emissions data, (iii) sustainability of emission trajectory for pathways (transition planning), (iv) expansion of investments and loans in Asian countries, and (v) increasing funds and other equity investments to GX.

In relation to item (i), for example, financed emissions (FE) is currently widely used as an indicator of the progress of financial institutions' transition plans. While this indicator has the advantage of being able to capture the emissions of all clients in a straightforward manner, the Guide has pointed out that there are issues specific to this indicator, such as the tendency for FE to temporarily increase at financial institutions that have financed large capital investments even toward emission reductions. In light of this, the Guide recommends that it is important to understand and explain progress of transition comprehensively, with using various indicators including qualitative ones, rather than using a single indicator. In addition, the Guide points out the concept of “avoided emissions,” as well as its potential roles and points to be born in mind in evaluating the indicator, from the viewpoint of evaluating emission reductions in society as a whole through new technologies or products.

In relation to (iii), the authorities of the G7 countries have developed an understanding of the need for companies to make a transition over a certain period of time in order to ensure the appropriateness and reliability of the transition plan. On the other hand, the understanding of transition finance, including that of private entities, is still in progress. For example, the Guide points out that it is important to improve the understanding and explanation of emissions reduction trajectory, its reliability, and its suitability for global targets and pathways published by research institutions. In addition, the Guide proposes to expand the range of products to accelerate the supply of equity required for the GX, and summarizes regional decarbonization efforts (see Chapter 2 (4) (b)).

As described below, the Government need to promote the GX for society as a whole. Within the Government’s initiatives, for example, the "Grand Design and Action Plan for a New Form of Capitalism" states that just transition will be supported through support for smooth labor mobility to growth fields and career change assistance for career advancement.

(Future issues and direction of measures)

Engagement between financial institutions and client companies toward Net-zero is in the implementation stage, and large financial institutions are also clarifying strategies and policies for engagement with non-financial companies. As a next step, they need to share ideas and methodologies in order to promote practices while obtaining understanding from a wide range of stakeholders. The above-mentioned report is significant in that it summarizes issues and measures based on discussions abroad such as in GFANZ, as well as efforts by domestic financial institutions. Therefore the authorities and financial institutions should collaborate to disseminate the report to a wide range of stakeholders.

At the G7 Hiroshima Summit, transition finance, in line with keeping a limit of 1.5°C temperature rise within reach, avoiding carbon lock-ins[40] and based on effective emissions reduction, has been emphasized as a significant role in advancing the decarbonization of the economy as a whole. As discussed at the Working Group, it is important to disseminate the importance and suitability of transition finance both domestically and internationally through the formation of specific projects.

At the same time, as stated in the report, strategies for transition and financing eventually need to be specific by each companies. On the other hand, there are no standards for company-by-company emission reduction trajectory. Companies are required to develop and explain transition plans based on individual consideration of factors such as the availability of new technologies. Financial institutions need to deepen their understanding of businesses, technologies, and firms' strategies, and accumulate judgments and knowledge. In this way, the implementation of transitions in Japan and overseas will promote understanding of eligibility and effectiveness, which will lead to further project formation. Make this virtuous cycle is a challenge for the future.

A new sovereign bond for financing GX investment will be issued over the next 10 years. The Government need to aim for the issuance and use of the bond to encourage active investment and financing by domestic and foreign investors and financial institutions while always keeping a close eye on the domestic and foreign situations.

In order to prepare transition plans and implement investments both in Japan and overseas, companies and financial institutions must hold various engagement and take strategic measures. On the other hand, for both non-financial companies and financial institutions, competition law issues may arise when a wide range of parties engage in discussions and deliberations on various business strategies.

In this regard, in February of 2023, the UK’s Competition and Markets Authority, for example, published a draft guidance that aims to help business to address climate change and environmental sustainability without undue fear of breaching competition rules.

In Japan, the Japan Fair Trade Commission ("JFTC") issued a guideline[41] in March 2023, stating that the act and competition policy can be recognized as complementing environmental policies. From the viewpoint of improving the predictability of businesses regarding the Antimonopoly Act, the JFTC clarified that "In many cases, the activities of enterprises, etc. toward the realization of a green society are not intended to restrain fair and free competition among them but rather have pro-competitive effects such as promoting the creation of new technologies and excellent products.” It also clarified that “if specific activities of enterprises, etc. are considered to have anti-competitive effects as well as pro-competitive effects, whether those activities pose any problem under the Antimonopoly Act is found by comprehensively considering both types of effects generated by the activities with the rationality of the activity’s purpose and the adequacy of the means employed for them.” The FSA and financial institutions

40 With regard to carbon lock-in, it has been pointed out that the introduction of large-scale facilities and other infrastructure causes CO2 emissions to remain high for a long time.

41 In March 2023, the Japan Fair Trade Commission (FTC) published "Guidelines Concerning the Activities of Enterprises, etc. Toward the Realization of a Green Society Under the Antimonopoly Act’".

need to carefully assess the actual situation of financial businesses to determine whether there are any additional special issues.

C) Expansion of GX Finance in Asia

- Japan should contribute to transition in Asia as a hub for GX -

As discussed in the aforementioned Working Group on Decarbonization, it is important to promote the implementation of transition projects not only in Japan but also globally, including emerging countries. In order to realize global decarbonization, in parallel with the progress of ambitious initiatives by developed countries, Japan needs to contribute to expanding initiatives in diverse regions, particularly in Asia, which has strong geographical ties.

(Future issues and direction of measures)

As in Japan, engagement with financial institutions and companies regarding the implementation of transition finance could possibly serve as a reference for Asian countries that seek to make medium- to long-term, transition under various energy and environmental constraints. Therefore, it would be better for the Government to consider this matter in cooperation with Asian countries while promoting various trials and initiatives in Japan. In addition, consolidating information and revitalizing human resources and funds related to GX investment in Asia, and utilizing Japan's financial functions to provide transition funds to Asia might possibly strengthen function as an international transaction base ("Asian GX financial hub").

All these concerned, the FSA needs to promote various measures that contribute to transition finance in Asia in collaboration with relevant ministries and agencies, authorities of relevant countries, business operators, financial institutions, etc. For example, there are similar projects in Asia and in Japan for the consolidation of corporate data or human resource development. The actual states differs from country to country, such as on finance, energy, and environment. Hence, Japan's relevant ministries and agencies need to closely cooperate and engage in concrete discussions with stakeholders in each country for the sake of the counterparties.

As for human resource development, as mentioned in (5), the FSA should consider disseminate private sector qualification examinations to train financial practitioners who are capable of handling GX projects, and run universities and public research institutes for courses on sustainable finance, including those of the global level. If these efforts would be coordinated with practitioners in Asia and the world, it might help effects toward carbon neutrality at the global level. In any case, not only to publicizing information, but also to taking specific measures to formulate actual projects are essential.

The FSA is planning to establish a consortium (tentatively called the Asian GX Consortium) involving public and private sectors, so as to provide financial or non-financial supports for formulating projects. There should be many issues to be discussed in this regard, such as the promotion of blended finance, transition strategy, and possibility of carbon credit creation, which could be shared with the Consortium.

As in May 2023 GFANZ Japan Chapter has been established as the first regional office of GFANZ, which could act as a forum for various international dialogue on measures to strengthen the response to net-zero and decarbonisation for domestic and global communities.

(4) Overarching issues

A) Promotion of impact investment;[42]

- Strengthen and promote sustainable finance through impact investment -

The initial report pointed out that from the perspective of realizing social and environmental effects (impacts) through investment and contributing to the benefits of the economy and society as a whole, impact investment[43], which aims to create "impacts" in parallel with returns, is attracting attention. It also pointed out that the challenge in promoting impact investment is to create a virtuous cycle in which impact evaluation methods and data are accumulated and the realization of impacts leads to the enhancement of corporate value.

With regard to impact investment, "Impact Investing Roundtable," co-hosted by the Japan National Advisory Board, the Global Steering Group for Impact Investment (GSG-NAB Japan[44]) and the FSA, was established in June 2020. In April 2023, the roundtable compiled and published a proposal for practical issues in conducting impact investment through loans and bonds, and made efforts to share knowledge. In November 2021, "Japan Impact-driven Financing Initiative" was adopted by private investors and financial institutions to voluntarily declare. As of the end of April 2023, 51 institutions have signed the declaration.

On the business side, various companies, including start-ups, large enterprises, and regional companies, are increasingly taking steps to address social issues and achieve growth. For example, in November 2022, the Impact Startup Association was established by entrepreneurs aiming to resolve social issues, and in June 2022, the Japan Business Federation put together a proposal for engagement between companies and investors that contributes to the promotion of impact indicators and *Purpose* management.

The FSA established the "Working Group on Impact Investment" under the Expert Panel in October 2022 to discuss the roles of impact investment, which is attracting increasing interest in Japan and abroad, and issues for its encouragement. The Working Group issued a report in June 2023.

The report shows that it would be fair to consider that impact investment plays essential roles as one of the fields of sustainable finance, in that it encourages support for companies engaged in introducing technologies and reforming business models that contribute to solving social or environmental issues, and in that it strengthens the foundations of economic and financial activities. On top of that, as an investment method, compared to investment methods based on ESG evaluations of companies that are widely used at present, 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".

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42 "Impact investment" includes not only investment (stocks and bonds) but also financial transactions such as loans and investment in real assets such as infrastructure. Collectively, they are called "impact investment."

43 It is not limited to equity investments, but also includes bond investments, loans, etc.

44 An international organization for impact investment led by the UK, which held the G8 presidency. Advisory committees have been established in 33 countries and regions, including Japan, to promote the practice.

More specifically, consistent with international discussions[45], impact investment is defined as an investment that aims to realize both "social or environmental impact" and "financial return". For impact investment the report points out following. Intended "social or environmental impact" and "profitability" is clarified, the strategies and causal pathways to achieve intended target are specified, and identify, measure and manage the "impact" and "profitability" that have actually been achieved. In addition, the report states the necessity to encourage business innovation in order to create a positive feedback loop of "impact" and "return."

In the report, the basic concept and principles of impact investment are summarized as "Basic Guidelines" that market participants can refer to when they form investments and raise funds, in order to foster a common understanding among market participants and promote investment practices.

In addition, the report proposes the establishment of a *Consortium* in which a wide range of investors, financial institutions, companies, related ministries and agencies, local governments, and organizations working on regional revitalization will gather, engage with mutual dialogue, and accumulate and improve experience and knowledge. The Consortium is expected to work on the aggregation and materialization of data related to social and environmental impact, sharing investment cases, meet-up with investors and companies, linkage with international databases and initiatives, and development of financial expertise, including intermediate methods between debt and equity financing. In this process, practical issues for producing actual investment projects will be discussed from the viewpoint that the consortium need to share financial methods and cases that suit the characteristics of various companies, such as start-ups, listed companies, and regional companies.

(Future issues and direction of measures)

Various ESG factors, such as environment, labor, and diversity, are the foundation of business operations and may manifest as risks in some cases. Therefore, it is significant for financial industry to address ESG issues from the financial side and strengthen the economic and social foundation.

There are various investment methods for sustainable finance, but in particular, investments based on ESG evaluations of companies, which are widely used, have played an important role in comprehensively evaluating companies' efforts to address ESG issues, including locating risks and encouraging engagements.

Impact investment has the same significance as sustainable finance in that it contributes to solving social and environmental issues through investment and improves the sustainability of investment and corporate activities in general by appropriately incorporating externalities into financial markets.

Therefore impact investment is expected to increase transparency and effectiveness of achievement regarding social or environmental impacts and financial return, and to appeal the significance to all stakeholders. The FSA expects that useful examples will be shared by the consortium mentioned above so that these developments will serve as a reference for the entire sustainable finance market.

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45 The report refers to the Global Impact Investing Network (GIIN), an international promotion organization for impact investment, and discussions in the UK and France.

In addition, the FSA and financial institutions are expected to support companies that aim to grow their business by addressing to social and environmental issues and to encourage innovation in society and business through impact investment because impact investment is characterized by the identification of individual strategies and causal pathways. In particular, impact investment has highly affinity for supporting start-ups that aim to solve social issues and gain profit .

There are great expectations for initiatives by local start-ups to create businesses that contribute to solving issues in local communities, urban areas, and the world, and to ensure business sustainability through various creativity and innovation.[46] However, for example, while there are various social issues in local areas, such as declining birth rate and aging population, the number of companies which seek to grow their business by addressing these issues and the support for these companies are not enough.[47]

Based on these perspectives, the FSA should deepen understanding and share knowledge among a wide range of stakeholders through careful dialogue with various entities in Japan and overseas. In addition to the FSA's public consultation towards the formulation of guidelines, the operation and development of a consortium involving various participants is expected.

B) Climate change responses in the region

- Acceleration of regional responses is indispensable -

As pointed out in the aforementioned report of the Working Group on Decarbonization, in order to achieve carbon neutrality, it is important not only for large enterprises in each industry to decarbonize themselves, but also for small and medium-sized enterprises (SMEs), which account for more than 90% of the number of enterprises in Japan and for 10-20% of Scope 1 emissions. The role of regional SMEs is important in terms of understanding emissions and establishing new technologies and production processes when implementing decarbonization efforts on a supply-chain basis.

Responses to climate change are expected to bring various benefits to regional SMEs. These include the possibility of reducing production costs through energy conservation, improving the competitiveness of products and enterprises through the evaluation of decarbonization initiatives by business partners and a wide range of individuals, and securing a competitive advantage in the medium- to long-term through the success of difficult issues such as energy conversion in advance.[48]

Many SMEs, however, face the need to address quite a wide range of business issues in parallel with a limited workforce. As a result, while recognizing the importance of addressing climate change, they face difficulties in doing so due to a lack of human resources, information, and funds.

(Future issues and direction)

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46 In the UK, for example, more than half of all impact startups are said to be launched outside of London, indicating that some startups are contributing to solving local social and environmental issues.

47 Of the 47 members of the Impact Startups Association (as of March 2023), 41 are headquartered in Tokyo. In addition, as of January 2020, around 80% of the funds raised by newly established enterprises in each registered location were raised in Tokyo.

48 See also Ministry of the Environment, "Initiatives for Local Decarbonization," and Ministry of Economy, Trade and Industry, "Carbon neutrality measures for SMEs." [available only in Japanese]

The Government has been communicating the importance of the role of SMEs, their potential benefits, and the need for support. Further enhancement of support and penetration measures is expected.

In the area of finance, regional financial institutions, which have close relations with regional companies, need to take the lead in improving their knowledge of the significance of decarbonization and the content of measures. In cooperation with the national government, local governments, and economic organizations and initiatives, financial institutions are expected to introduce and promote supporting projects provided by the Government and local authorities, provide consulting services such as emissions measurement and energy conservation support and promote a range of aspects in cooperation with regional companies.

In particular, regional financial institutions need to deepen cooperation among the government, local governments, societies of commerce and industry, economic organizations, major manufacturers, energy companies, etc. in each region.

For example, there are various issues involved in promoting the GX in local areas, such as the creation of businesses, meet-up of supply and demand for funds, and local energy strategies. In order to grasp the issues and advance efforts toward specific solutions, cooperation among various parties concerned is essential.

In terms of financing, GX investment in renewable energy requires not only independent financing by private financial institutions but also various schemes such as project finance, securitization, blended finance, etc., as the initial amount required is large and it takes time to gain the investment return. In order to cope with this situation, the related ministries and agencies would better cooperate to support the establishment of a consultative body of local stakeholders and the formulation of a local GX plan, and deepen the understanding of a wide range of strategies among the stakeholders.

- Concrete support is also needed for data development in the regions -

Local initiatives are also important to ensure the collection and quality of ESG data. In particular, various discussions are being conducted by companies regarding the aggregation and disclosure of Scope 3 emissions data. However, practical challenges exist, particularly when measuring and estimating the emissions of upstream and downstream business partners.[49]

Many companies calculate emissions (secondary data) using estimated values, which are calculated by multiplying activity volumes by carbon intensity. In order to collect more accurate actual numbers (primary data), there is the administrative burden of sending questionnaires to a large number of business partners and compiling them. In addition, companies, mainly SMEs, asked for figures, face the following challenges: (i) a SME is required to use different measurement formats and methods by each business partners; (ii) calculations are difficult, such as allocating factory emissions to the products of business partners; and (iii) individual trial and error is inevitable because there is no dedicated person in charge of calculating emissions and industry associations have not completely established their own initiatives.[50]

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49 According to the Japan Exchange Group's Survey of Information Disclosure in Line with the TCFD Recommendations (fiscal year 2022), 48% of companies disclose scope 3 emissions.

50 Estimates are often calculated by multiplying activity volumes by emission factors. In this case, however, the emission reduction efforts of individual companies are not necessarily reflected, and the administrative burden of carefully reflecting the situation of individual companies can be an even greater challenge.

(Future issues and direction)

In recent years, services for measuring and managing emissions using cloud technology have been developed, and large and regional financial institutions are providing support services through partnerships. The financial institutions and related companies need to improve the quality of data by actively utilizing these technologies. In particular, regarding Scope 3 emissions data, there are cases where companies have no choice but to make rough estimates. Therefore, it is appropriate for stakeholders to use scope 3 data based on an understanding of the characteristics of figures. It is expected that relevant ministries and agencies will cooperate to verify specific issues so that multiple financial institutions can efficiently and effectively obtain Scope 3 emissions data.

In addition, the Working Group on Decarbonization summarized various issues surrounding regional financial institutions. As described in 2 (2) (a), the public and private sectors need to cooperate to prepare data on emissions in the supply chain. As a prerequisite for this, they need to have a grasp of the supply chain, which is also challenge. The working group also proposes measures to improve the usability of subsidies and strengthen collaboration among financial institutions through local finance bureaus, etc. Through these measures, the FSA is required to revitalize regional financial institutions' initiatives toward carbon neutrality.[51]

C) Discussions and future perspectives on natural capital and biodiversity;

- Important to deepen consideration of risks and opportunities while taking into account international trends -

With regard to natural capital, including biodiversity, international discussions are underway on disclosure and risk analysis, based on the G20 recommendations.[52]

Regarding disclosure, the TNFD (Taskforce on Nature-related Financial Disclosures), which was launched by private sector investors and organizations in June 2021, plans to publish its final recommendations in September of this year. The ISSB also listed biodiversity, ecosystems, and ecosystem services[53] for new projects in a public consultation on priority issues for the development of sustainability disclosure standards in May 2023.

With regard to risk analysis, the NGFS established a dedicated “Taskforce on Nature-related Risks” in April 2022 to sort out a conceptual framework for the analysis of nature-related financial risks.

(Future measures and direction)

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51 With regard to the penetration of government support measures into financial institutions in collaboration with related ministries and agencies, the Government is working to enhance these measures by, for example, enhancing and presenting a collection of carbon-neutral measures for SMEs, and it is expected that measures will continue to be taken.

52 The G20 Sustainable Finance Roadmap, published in October 2021, lays out future actions on disclosure and risk analysis related to nature and biodiversity.

53 Biodiversity includes "diversity within species," which refers to the diverse individuality of the same species; "diversity among species," which refers to the existence of various living creatures; and "diversity of ecosystems," which refers to the existence of various types of nature. Ecosystems are formed when living creatures and the surrounding environment interact with each other. Ecosystem services are the blessings of nature provided by ecosystems.

At the G7 Minister of Finance and Central Bank Governors Meeting in May 2023 (see page 6), the G7 expressed that "we look forward to the ISSB's future work on disclosure on biodiversity and human capital." The public and private sectors should deepen understanding of stakeholders on the risks and opportunities related to biodiversity, while paying close attention to international trends such as the solicitation of opinions on the ISSB.

In terms of risk analysis, it is beneficial for the authorities to carefully examine risk-transmission mechanism to financial institutions and financial systems. For example, what kind of ecosystems the wide range of economic activities are based on, how regions and industries could be affected if natural capital is damaged, and whether other capital could be substitute to continue business operations, etc.

In addition, the government needs to participate in international discussions, including the 16th Conference of the Parties to the Convention on Biological Diversity (COP16), which is scheduled to be held in Turkey in the second half of 2024.

(5) Human resource development

The Second Report points out that the development and enhancement of human resources with expertise in the promotion of sustainable finance is an important issue, whether viewed by actors-level: investors, financial institutions, securities companies, rating providers, or by transaction level: investment, financing, and disclosure, etc. The lack of human resources is becoming apparent as a side effect of the progress of sustainable finance initiatives, and comprehensive initiatives across sectors and ages would be necessary.

The Expert Committee discussed the Skill Map for human resources, which was drafted by the FSA in September 2022, and classified the knowledge necessary to promote practical operations into three broad categories: I. Issues and Significance of Sustainability; II. Knowledge and Practice of Sustainable Finance; and III. Soft Skills for Promoting Collaboration and Engagement with Various Stakeholders. The Map pointed out the importance of a wide range of stakeholders in the financial sector developing expertise based on specialized knowledge in their respective fields and at the same time developing cross-sectoral initiatives through the accumulation of soft skills and interdisciplinary ideas and practices.

Based on the structure of the Skill Map, the FSA has conducted a questionnaire survey to a wide range of financial companies, including large and regional financial institutions, securities companies, insurance companies, and asset managers, through industry associations in order to identify the actual situation and issues such as human resource shortages.[54] The following issues were identified in the questionnaire.

- Human resource are especially necessary for climate change, biodiversity, impact investment, etc. -

When asked whether the number of employees engaged in sustainable finance practices

54 The survey was conducted through various industry associations between April and May of this year. Responses were received from 11 (4%) city banks, 56 (18%) regional banks I, and 33 (11%) regional banks II. 9 (3%) Shinkin banks, 42 (14%) credit unions, 69 (23%) life and non-life insurance companies, 42 (14%) asset management companies, and 42 (14%) securities companies. (Figures in parentheses are percentages of total number of institutions, same as below)

is sufficient for each knowledge shown in the Skill Map, approximately half of the responding organizations responded that they "lack human resources" in at least one of the fields. Approximately 10% of organizations responded that they "do not have any particular human resource shortage," and approximately 40% of organizations responded that they "do not know whether there is a human resource shortage." [55] When limited to large financial institutions, asset managers, and life and non-life insurers, approximately 70% of the organizations in total responded that they "lack human resources" in any of fields.

In terms of ESG issues for which human resource shortages were identified, climate change was cited by 36% of organization, biodiversity by 35%, human rights by 27%, circular economy by 24%, and risk management by 20%. In terms of knowledge and practices, "domestic sustainable finance policy trends, etc." was cited by 20%, "impact investment" by 20%, "overseas sustainable finance regulation and policy trends, etc." by 17%, "transition finance and financing with sustainability assessment" by 16%, and "formulation of management and business strategies incorporating sustainability perspectives" by 15%. Biodiversity and impact investment, which were listed at the top, are both areas of increasing interest in recent years, suggesting that the needs of financial businesses are changing sequentially.

- Focusing on internal training rather than mid-career recruitment -

When asked about methods for enhancing human resources that are insufficient, 43% responded that they are "not actively hiring but conducting internal training," while 14% responded that they are "changing jobs at the employee's request." Around 10% responded that they are using "mid-career recruitment," with financial institutions and asset management companies accounting for the majority. Around 2% responded to both "hiring of new graduates" and "accepting secondments".

Of the institutions that use "mid-career recruitment," approximately 60% responded that they "have been able to hire but are insufficient for the required number of people," and approximately 40% responded that they "have not found appropriate human resources." Regarding the desirable careers of mid-career human resources, approximately 80% of organizations that use "mid-career recruitment" answered "human resources with experience in sustainable finance at other companies in the same industry," approximately 50% answered "sustainability-related consulting business," approximately 30% answered "working experience at an ESG evaluation organization," and approximately 20% answered "experience at the Sustainability Office of a business company," with "experience at an NGO or NPO," "sustainability-related research institute," "practical experience overseas," and "working experience at an overseas base of another company in the same industry" all accounting for around 5%.

- Expectations for training by industry associations and networking by other companies in the same industry -

55 Many of the institutions that responded that they "do not understand whether there is a shortage of human resources" are institutions whose main business is not to raise funds or small financial institutions. Some industry associations expressed the opinion that many of their business partners are small business operators, and that they may not have an image of human resources because they are facing urgent top priorities such as business improvement and revitalization due to the COVID-19.

Regarding support for acquiring the knowledge of staff involved in sustainable finance, about half of the institutions surveyed said that they are providing training in one form or another, 31% said they “do not have staff in charge,” [56] 14% said they “plan to develop systems while asking to the needs of staff in charge in the future,” and 10% said they “understand the need for education but are in trouble because they do not know how.” No institution answered that there is no particular need for education for staff in charge.

As for measures to foster personnel, 41% of the institutions responded that they are conducting "internal training, including at group companies," followed by "transfer within departments or on-the-job training" (38%), "external training" (33%), and "participation in initiative events, etc." (20%). Less than 10% of institutions responded "collaboration with universities and other research institutions" or "collaboration with NGOs or NPOs." Around 20-30% of city banks and asset management companies responded that they are conducting "collaboration with universities and other research institutions."

"External training by industry associations," "networking among staff from other companies in the same industry," "external training by private companies," and "partnerships with NGOs or NPOs with expertise," and "partnerships with universities and other research institutions" each represent 50%, 36%, 28%, and 10% or less, respectively, of the nurturing methods that enterprises want to consider or would like to have in the future, indicating that emphasis is being placed on sharing practical experiences and cases in the same sector.

In addition to training, regarding qualifications, 19% of organizations are currently using and 19% are planning to use "sustainable finance related qualifications" as a method of developing staff. When asked about the ideal concept of qualifications for internal use, approximately 30% answered that "continuous training is available for renewals after qualifications are obtained," 23% answered that they "do not know," followed by 16% who answered that "grades are given depending on the level of knowledge," and 13% who answered that "there is no renewal of qualifications, and basic knowledge can be acquired with one qualification."

- Some Financial institutions are reaching out to various segments of the population, including university students -

When asked about the implementation of courses, events, provision of teaching materials, etc. including sustainable finance, 27% said, "implemented for elementary, junior high, and high schools," 22% said, "implemented for university students (including endowed courses)," and 15% said, "implemented for adults." The percentage of institutions that "implemented specialized content for financial educators such as financial planners and teachers" was 6%. In total, around 40% of institutions are implementing education in one form or another.

When asked whether their initiatives on sustainable finance are being communicated in the process of hiring new graduates, 46% said they have no plans to do so, and 23% said they plan to do so in some way in the future. This was followed by 16% for both "communication through recruitment websites for new graduates" and "communication at briefings for students."

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56 Industry associations pointed out that some of these small financial institutions face difficulties in establishing a dedicated department due to the limited number of staff they have.

(Future issues and direction)

- Securing internal human resources with business-ready capabilities and practical capabilities is an urgent task in the short term -

The need for internal training is higher than that for mid-career recruitment, and the results of expectations for training methods such as training by industry associations and networking indicate that finance-related businesses lack personnel with immediate capabilities who are familiar with the status and issues of their own or their sector and who can smoothly lead to the implementation of sustainable finance internally.

Industry associations, private businesses, universities and research institutes, and the FSA may work together to hold regular courses on sustainable finance, develop teaching materials, and collect case studies or best practices. In the UK, for example, university research institute is providing training to bank staff.[57] In Japan, there are also examples of universities opening sustainable finance courses for workers, including financial institution staff.[58] There are also examples of universities and financial institutions working together to develop sustainable finance products.[59] Further collaboration with universities is important.

- Long-term human resource development is also essential -

On the other hand, in order to increase the depth of human resources, from a long-term perspective, the FSA also need to encourage exchanges and fostering of a wide range of human resources, and to take measures to expand human resources who can be involved in the promotion of sustainable finance in a wide range of places such as financial businesses, business companies, profit and non-profit organizations, and universities.

At present, the development of internal human resources at financial institutions is an issue, but for example, human resource exchange and development across industries is also considered to be an important issue in the medium term. According to the questionnaire, it seems that mid-career recruitment is not necessarily fully utilized at present. In general, financial institutions would better consider to form a pool of a wide range of professional human resources and utilize this pool to promote human resource exchange across industries as a measure to supplement human resources who can respond to the latest issues and deepen diverse knowledge[60], while utilizing flexible working styles without being caught in the office and considering collaboration with other industries and research institutions.

For this reason, financial institutions would also better increase partnerships across industries, commercial and non-commercial sectors. For example, in the area of

57 "Work to Understand the Climate Change Response of SMEs in the Region and Support by Financial Institutions." Specific examples are introduced on p. 33 of the report.
https://www.fsa.go.jp/common/about/research/20230407/02.pdf [available only in Japanese]

58 For example, Aoyama Business School has been offering a certificate program, Sustainability Management, since January 2023, and the Graduate School of the University of Tokyo has been offering the Sustainable Finance School since June 2023. Some graduate schools, such as the University of Tokyo, have established an advisory board consisting of several experts in sustainable finance and plan to offer lectures.

59 The report, "Work to Understand the Climate Change Response of SMEs in the Region and Support by Financial Institutions" includes several examples of cooperation between regional financial institutions and universities.

60 By creating a database of past job seekers, retirees, experts from other companies, etc., and creating a pool of human resources, there are methods to recruit through periodic contact, etc.

decarbonization, NZAOA is using university models, the LSE is collaborating with the London Stock Exchange to run a framework (TPI[61]) to assess the status of emissions reductions by high-emission companies, and GFANZ is inviting research institutions and NGOs to its advisory panel to obtain knowledge from scientific analysis. Through such partnerships, financial institutions are expected to develop knowledge and human resources across industries.

In addition, the financial institutions and the FSA need to provide knowledge to interested parties before they engage in actual business, i.e., from school age, so that it will lead to the development of financial practitioners in the future. The survey results indicate that a considerable number of financial institutions are interested in disseminating information on sustainable finance initiatives through lectures and recruitment activities at universities. For example, more courses at universities and internships on sustainability may be considered to increase interest in sustainable finance.

From the perspective of providing a wider range of knowledge, the organization for financial and economic education promotion is scheduled to be established in 2024. Financial and economic education is expected that the methods to support the achievement of the SDGs through deposits and investment and the significance of ESG investment will be further permeated among a wide range of generations. In addition, in light of the expansion of financial and economic education through the revision of the high school education guidelines in April last year, the Japanese Bankers Association (JBA) has developed teaching materials[62] on sustainable finance for high school students and is deploying them in schools.[63] In addition, financial and economic education is expected to be further permeated through various teaching materials such as the provision of teaching materials that can be enjoyed like a game by the Japan Securities Dealers Association (JSDA) and others conducted through the Securities Industry Knowledge Dissemination Project[64], and the Study Group for Promoting Financial and Economic Education, for which the JSDA serves as the secretariat.

The voices of the next generation, who may be strongly affected by issues related to sustainability, are indispensable in the promotion of future policies. Based on this, devising methods of education and dialogue, such as continuously enhancing interactive dialogue, is also important.

61 Transition Pathway Initiative

62 "Sustainable Finance for Beginners Let's Save the Earth in a Pinch with the Financial Power“ https://www.zenginkyo.or.jp/education/material/sustainable-finance/ [available only in Japanese]

63 Some educational institutions commented that "SDGs are always covered in high school, but ESG investment has never been covered in detail, so it would be beneficial.” It would be useful to develop sustainable finance as part of SDG education.

64 The Japan Securities Dealers Association, JPX, and The Investment Trusts Association, Japan, are among the participants.

3. Next Step - Towards the Materialization of Sustainable Finance

Since the publication of the Initial Report, considerable progress has been made in the implementation of necessary measures and systems, such as the enhancement of sustainability information disclosure, formulation of codes of conduct for ESG evaluation and data providers, revision of supervisory guidelines for financial instruments business operators, and publication of guidance for financial institutions.

On the other hand, discussions are becoming increasingly active at home and abroad regarding the transition and the path toward decarbonization. In addition to climate change issues, issues that sustainable finance should consider are expanding and becoming more serious, such as biodiversity and ecosystem protection, the widening of economic disparities, the declining birth rate, human capital, and human rights issues. While there are some movements in some parts of the world to restrict ESG investment, the PRI has advocated the idea of "Investing for Sustainability Impact (IFSI)," which is a broader concept as a field of sustainable finance, and proposed to clarify the legal interpretation.

In light of such diverse circumstances, it is time to discuss again the broad direction of sustainable finance in Japan, including the ideal direction of this Expert Panel itself, beyond the framework of individual policy measures. In other words, the Panel and the FSA should move forward from the first stage of establishing awareness of sustainable finance to the second stage of elevating, deepening, and materializing its contents.

This Expert Panel has so far played roles in providing a bird's eye view of developments related to sustainable finance. From the next fiscal year, the Panel will further proactively engage in discussions by taking up important issues from broad perspectives, such as expanding the range of related parties including asset owners, considering impacts over the long-term timeframe, organizing further discussions and ideas on fiduciary responsibilities, and allocating roles such as what should be left to the autonomous judgment of the market and what should be supported by the government policies, in terms of promoting sustainable finance in Japan and the world.