PRI RESPONSE

JAPAN CABINET SECRETARIAT ASSET OWNER PRINCIPLES PROPOSAL CONSULTATION

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PRI Association

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An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the Japanese Government's Cabinet Secretariat's call for feedback on the draft Asset Owner Principles.

ABOUT THIS CONSULTATION

In June 2023, the Cabinet decided on the Basic Policy on Economic and Fiscal Management and Reform 2023 and the Grand Design and Action Plan for a New Form of Capitalism 2023 Revised Version. Building upon existing policies pursuant to the Doubling Asset-Based Income Plan and the Action Program for Accelerating Corporate Governance Reform, the Cabinet newly introduced a policy to promote Japan as a leading Asset Management Center, recognizing the need for policies to comprehensively address various actors in the investment chain to achieve the "virtuous cycle of growth and distribution" that the New Form of Capitalism policy aims for.

In October 2023, the FSA established the Asset Management Task Force and published the findings from the Task Force discussions in December 2023. These findings, alongside inputs from other government forums such as the Working Group on Capital Market Regulations, informed the Cabinet Secretariat's Policy Plan for Promoting Japan as a Leading Asset Management Center, published in December 2023, which included the plans to publish "Asset Owner Principles" by summer 2024.

Between March and June 2024, a working group under the Cabinet Secretariat's Headquarters for Achieving New Capitalism met four times to discuss the contents of the proposed Asset Owner Principles. On 24 June 2024, the Asset Owner Principles (Proposal) was published and open to public comments until 25 July 2024.

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KEY RECOMMENDATIONS

The Asset Owner Principles (Proposal – hereafter referred to as the Principles) is an important step taken by the Japanese Government to encourage asset owners in Japan to take an even more active role in pursuing beneficiary interest. We welcome the comply or explain approach as explained in the Principles as it will enable better accountability and transparency by asset owners on how they are considering, pursuing and progressing on the key objectives and policies for the best interest of beneficiaries. We also welcome the incorporation of core principle 5 requiring asset owners to consider necessary measures such as direct or indirect stewardship activities for the sustainable growth of investee companies where this aligns with the return goals of beneficiaries. It is also important that the Principles recognize, in supplementary principle 5-2, that long-term investment returns can potentially be improved through “sustainable investment” by promoting growth among investee companies, which contributes to the sustainable growth and development of the broader economy.

The PRI’s key recommendations are:

- Supplementary Principle 1-1:
    - Clarify that in the process of identifying who the beneficiaries are and ascertaining investment objectives, asset owners should engage with beneficiaries and consider their sustainability preferences
- Supplementary Principle 1-2:
    - Clarify that asset owners should consider whether the achievement of a relevant sustainability goal is ‘instrumental’ in realising their financial return objective.
    - Clarify that where a sustainability-related factor, including those related to system-level risks, is identified to be important in achieving investment objectives aligned with beneficiaries’ best interest, asset owners can set sustainability objectives.[1] This would be in line with supplementary principle 5-2.

Further to the Principles, the PRI recommends:

- Consideration of providing additional guidance on specific sustainability issues and how asset owners should approach these issues as universal owners.
- Consideration of revision to the stewardship code to encourage incorporation of system-level risks, including from a sustainability perspective, and engagement with beneficiaries on broad preferences, including on sustainability. Although the stewardship code is not within the remit of the Cabinet Secretariat, this recommendation would allow the Japanese Government to maintain consistency between our recommendations to principle 1 made above, and the stewardship code that is referred to in supplementary principle 5-1.

[1] Based on legal analysis of the A Legal Framework for Impact and our policy analysis, in the report A Legal Framework for Impact Japan: Integrating Sustainability Goals Across the Investment Industry, we provide recommendations to clarify investor duties – particularly in the sense of clarifying that investors should consider pursuing social and environmental impact goals where they can reasonably be expected to help achieve their legal investment purpose and objectives – for example by serving to address sustainability-related system-level risks.

DETAILED FEEDBACK

The PRI recognizes the critical role that asset owners play in mainstreaming responsible investment. The empowerment of asset owners is a central priority in the 2017 PRI Blueprint, our vision of how the PRI and the wider responsible investment community should progress over the next 10 years. We also recognize the importance of policy interventions regarding how investor duty is understood in the context of responsible investment, as well as regarding policies that enhance the market conditions in which investors pursue responsible investment within their duties. Our thought leadership in this area most recently comes from the A Legal Framework for Impact project, where we also published a Japan-specific report that incorporates policy recommendations to support asset owners by clarifying how they should interpret responsible investment practices in the context of their duties and by providing practical guidance and support to progress practices where permissible or required. The need for such comprehensive and consistent policy frameworks on asset owner expectations was also found in our analysis of sustainability in key pension systems published this year.

While we welcome the inclusion of supplementary principle 5-2 for asset owners to consider “sustainability investments” that contribute to the sustainable growth of investee companies where necessary based on stakeholder preferences and investment objectives, this does not provide enough clarity on circumstances where it is permissible for asset owners to pursue sustainability goals and where this is required. It also provides a potentially misleading impression that sustainability is confined to alternative investment options rather than something to be embedded into investment decision making.

This clarity is best provided through revisions to Principle 1 because it provides guidance on how investment objectives, goals and policies should be considered, which ultimately dictates how all other Principles are implemented. If the sustainability preferences of beneficiaries and the risks that sustainability factors pose to the pursuit of investment objectives are considered in Principle 1, the consideration of sustainability goals can be embedded throughout the application of the principles. For example, if sustainability contributes to the best interest of beneficiaries, appropriate sustainability capabilities should be developed within the asset owner (Principle 2), processes to appoint and monitor investment managers should integrate appropriate sustainability capabilities (Principle 3), and asset owners should be transparent and accountable regarding the management of sustainability objectives and progress made (Principle 4).

Additionally, we recommend that the Government consider providing asset owners with general guidance beyond these Principles that aids them in their decision-making on key sustainability issues in the context of their duties, as well as consider revising the stewardship code to include principles regarding engagement with beneficiaries and the consideration of system-level risks.

PRINCIPLE 1: INTEGRATE SUSTAINABILITY-RELATED SYSTEM-LEVEL RISKS AND RELEVANT OBJECTIVE-SETTING AS A FUNDAMENTAL CONSIDERATION FOR ASSET OWNERS

Principle 1 importantly notes that "asset owners should take into account the best interests of beneficiaries" in their process to "determine the purpose of investing, and then set investment targets and policies". However, while it clarifies that asset owners should "take into account" the best interest of beneficiaries, it does not clarify how asset owners should do this. From a responsible investment perspective, we recommend that the Principles **clarify that asset owners should do so by engaging with beneficiaries, and in the process, ascertain the sustainability preferences of beneficiaries**.

Research featured in A Legal Framework for Impact suggests consumers commit fewer assets to sustainable investments than surveys suggest they will.[2] This issue is compounded in Japan by a relative lack of financial literacy. Studies compiled by the Cabinet Secretariat[3] have shown that Japanese consumers are less inclined to invest their money in financial products, compared to consumers in other countries such as the US and the UK. As such, the Government has already begun to promote policies to improve financial literacy in Japan through initiatives pursuant to the Doubling Asset-based Income Plan. However, there remains an important role that asset owners can play to actively engage with beneficiaries.

Supplementary principle 1-2 notes that "asset owners should set investment targets to achieve the investment purpose, such as specific returns and tolerable risks, taking into account the kinds of their funds, their capabilities and AUM, and a long-term forecast of the economic and financial environment." However, despite the increasing awareness of the importance of sustainability-related risks, especially those with system-level implications, to long-term returns, the principle does not explicitly refer to sustainability as a factor that should be considered in this context. From a responsible investment perspective, we recommend that the Principles **clarify that asset owners should consider whether the achievement of a relevant sustainability goal is 'instrumental' in realising their financial return objective**.

Asset owners such as pension funds are long-term investors and their ability to generate long-term returns relies on the performance of the markets and economies in which they invest. Because sustainability factors such as climate change and biodiversity loss threaten the performance of the markets and economies on which they rely for financial returns, they have a responsibility to consider whether sustainability-related risks, including those that are considered system-level risks, will inhibit their ability to protect long-term value and provide adequate value to their members or beneficiaries.[4]

The PRI's policy analysis finds that legislative and regulatory frameworks should explicitly require asset owners to consider such risks. Such policies can clarify that asset owners can and should consider sustainability-related systemic risks, set related sustainability goals (including by reference to the achievement of global objectives such as the Paris Agreement goals and the UN Sustainability Development Goals), and pursue them through a combination of investment decisions, stewardship,

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[2] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making (p.60)

[3] Cabinet Secretariat (2022), 資産所得倍増に関する基礎資料集

[4] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making

and, where applicable, policy engagement. Especially regarding setting sustainability objectives, the Principles should **clarify that where a sustainability-related factor, including those related to system-level risks, are identified to be important in achieving investment objectives aligned with beneficiaries' best interest, asset owners can set sustainability objectives.**

Examples of such policy interventions to better enable the integration of sustainability factors into how asset owners such as pension funds understand their duties are emerging globally. For example in Australia, the Australian Prudential Regulation Authority (APRA) introduced SPG530 Investment Governance, which notes that pension funds may incorporate "environmental or social impact related objectives, where it can demonstrate that pursuing such additional objectives is consistent with the outcomes the Registered Superannuation Entity licensee seeks to provide beneficiaries". In the EU, the European Insurance and Occupational Pensions Authority (EIOPA) has consulted and published a technical report for the review of the Institutions for Occupational Retirement Provision (IORP) II Directive. The report states that "IORPs should be required to pursue positive sustainability goals in their investment and engagement activity if it is in line with the members' and beneficiaries' preferences and it is in their long-term best interest."

POTENTIAL CONSIDERATIONS BEYOND THE ASSET OWNER PRINCIPLES: ADDITIONAL SUSTAINABILITY ISSUE-SPECIFIC ASSET OWNER GUIDANCE

Guidance on how investors, including asset owners, should consider sustainability issues is being introduced in jurisdictions around the world. For example on the theme of climate change, the Australian Prudential Regulation Authority (APRA) introduced CPG 229 Climate Change Financial Risks in 2021 and on the theme of social issues, the UK Department for Work and Pension's Taskforce on Social Factors introduced the Guide on Social Factors: Considering social factors in pension scheme investments. Although not government-led guidance, the UK Financial Markets Law Committee published the paper Pension Fund Trustees and Fiduciary Duties: Decision-making in the context of Sustainability and the subject of Climate Change.

In Japan, the FSA introduced the Supervisory Guidance on Climate-related Risk Management and Client Engagement in 2022, but it does not explicitly apply to pension funds. We recommend that the Cabinet Secretariat and other relevant ministries, including the Ministry of Health, Labour and Welfare, cooperate with the FSA to develop thematic guidance that practically supports Japanese pension funds. To a certain extent, such guidance may support the skills and resources gap among pension funds that are beginning to consider the incorporation of ESG issues and sustainability impacts.

POTENTIAL CONSIDERATIONS BEYOND THE ASSET OWNER PRINCIPLES: REVISIONS TO THE STEWARDSHIP CODE

In Japan, The Principles for Responsible Institutional Investors, known as Japan's Stewardship Code, has been instrumental in legitimising and promoting stewardship activities in the market. Mention of the Stewardship Code in the Asset Owner Principles will be an important step that drives further involvement of asset owners in the stewardship space.

Similarly to sustainability-theme specific prudential guidance explored above, some jurisdictions around the world such as the UK[5] are clarifying the permissibility and expectation for investors to consider system-level risks, including those related to sustainability-related factors such as climate change, and the consideration of engagement with clients and beneficiaries through the stewardship code. Incorporating such principles in Japan's Stewardship Code can provide better clarity to asset owners on their permissibility and expectations to understand beneficiary preferences on sustainability issues and also consider tackling the drivers of certain sustainability-related risks that have market-wide, system-level implications to their entire portfolios.

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of the Japanese Government to further to develop guidance for asset owners in Japan.

Please send any questions or comments to policy@unpri.org.

More information on www.unpri.org

[5] Financial Reporting Council. December 2019. The UK Stewardship Code 2020 (p.11, 13-14)