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The Social Role of Corporations in Asia-Pacific

The Rapid Growth of ESG in Japan Through Public-Private Partnership

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Japan has long been characterized as a stakeholder-oriented system, in which the interests of employees and other constituencies outweigh the interests of shareholders. Historically, Japan looked to Germany as its prime source for commercial and corporate law, and was influenced by the premise in German corporate law that corporations will act for the greater public good rather than solely for private gain.

Japan's postwar economic success gave rise to an image of an economic system that preferred informality over law, with governance dominated by management insiders and focused on ties with stakeholders such as lifetime employees (the center of a "company community"), affiliated companies, and main banks. The bursting of Japan's economic bubble in the early 1990s prompted calls for change, including corporate governance reform to achieve greater international competitiveness and better investor returns at Japanese companies.

Reforms were gradual, as Japan found it difficult to reconcile its traditional practices with demands from global institutional investors and domestic reformers for American-style mandatory monitoring by independent directors. Following the 2008 financial crisis, Japan began to give greater consideration to soft law approaches (best practice codes enforced by "comply or explain" provisions rather than legal obligations) that are associated with the UK. The reform process accelerated from December 2012 under the Abe administration, which emphasized corporate governance as one of the pillars of structural reform to achieve higher growth rates. The enactment of a Stewardship Code (2014)[1] and a Corporate Governance Code (2015)[2], with subsequent revisions every three years, has resulted in substantial change: a significant increase in the number of independent directors, increasingly active domestic institutional investors, and greater consideration given to shareholder interests.

Current debate in Japan focuses on the extent to which these changes in corporate governance structure are resulting in substantive changes in practice. For example, now that the number of independent directors has increased, what is their function and how effectively do they perform it?

ESG in Japan

Japan was initially a laggard in embracing ESG as a formulation for the social role of corporations. It focused strongly on substantive policies such as environmental controls, but as of a decade ago had almost no independent directors and scored poorly in international governance rankings. Thus, Japan had a strong "E," a moderate "S," and a poor "G."

Japan has now fully embraced ESG concerns. A key driver of this change has been the Government Pension Investment Fund (GPIF), which is the world's largest pension fund with $1.7 trillion in assets.[3] In 2015 it signed the UN's Principles for Responsible Investment. In 2017 it began allocating substantial funds to ESG investments, clearly disclosing its allocation and the ESG funds selected for investment. At the same time, GPIF requested its external asset managers to take ESG into consideration in making investment decisions and revised its guidelines for external asset managers to emphasize stewardship and ESG activities.[4] In response, companies in Japan began to emphasize their ESG activities and ESG ratings to appeal to the GPIF and other institutional investors. Japan has relatively dispersed shareholders and few controlling shareholders, so that institutional investors own a substantial portion of the market and are in a position to exert influence over Japanese companies.[5]

As a result, ESG assets grew rapidly. The Global Sustainable Investment Alliance reports that ESG assets in Japan totaled roughly $2.9 trillion (310 trillion yen) in 2020, an increase of 34% since 2018, and that this total amounted to 24% of all Japanese assets under management.[6] This places Japan behind the EU and the US globally, but makes it a leader within Asia-Pacific.

Expanding Disclosure Requirements

More than 120 countries including Japan and the EU are aiming for carbon neutrality by 2050. Japan has set a 30-year interim target to reduce CO_2 emissions by 46% from 2013 levels. Since Japan depends on fossil fuels for about 90% of its primary energy supply and 75% of its electricity generation (and about 85% of its greenhouse gas emissions are energy-derived CO_2), the realization of a decarbonized society will require rapid and far-reaching changes and transitions in all sectors, including energy, buildings, infrastructure (including transportation), and industry.

This continued reliance on fossil fuels poses a great challenge to achieving the goal of carbon neutrality, and has contributed to the widespread view that Japan lags behind the EU and US in its response to climate change. The problem is exacerbated by reluctance in Japan to utilize nuclear power plants following the Fukushima disaster in 2011.

The means Japan has adopted to achieve carbon neutrality are broadly similar to its approach to corporate governance reform generally: reliance on a public-private partnership between government and industry, together with gradual implementation of the necessary standards and practices. Implementation usually begins with a voluntary, soft law approach. After the new practices become established and the ability of industry to comply is affirmed, mandatory, hard law requirements are eventually introduced.

The disclosure of climate change risks by companies is a clear example of this process, in keeping with the global trend of following the recommendations of the Task Force on Climate-related Financial Disclosure (TCFD). In Japan, the government's policy of encouraging the adoption of international standards was a key component. Following TCFD's publication of recommendations of climate-related disclosures in 2017, the GPIF accepted these recommendations in December 2018 and began making TCFD-based disclosures in 2019. At the same time, related government agencies backed the formation of a TCFD consortium in 2019, which included listed companies, institutional investors, and other related parties. The consortium published two guidance documents on climate-related disclosures: TCFD Guidance 2.0 for companies and Green Investment Guidance for investors.[7] Japan now has the highest number of organizations in the world supporting the TCFD recommendations (726 as of February 2022).[8] Unlike other countries, more support comes from corporations than financial institutions.

Once a uniform set of disclosure requirements is established, it will be easier for managers to operate their businesses in an environmentally friendly manner. And investors, such as pension funds, who value environmental responsiveness from a long-term perspective, will have more material on which to base their decisions. With the reclassification of market segments of the Tokyo Stock Exchange beginning in April 2022, companies listed on the highest-tier Prime Market will be required to disclose information based on TCFD's recommendations. In addition, on September 2, 2021, the government's Financial Services Agency began considering a requirement that all listed companies disclose information related to climate change risk and corporate governance. This disclosure requirement is expected to be implemented by 2023.

A new principle (Principle 2.3) on "Sustainability Issues, Including Social and Environmental Matters" was added to the Corporate Governance Code in June 2021. Demands from investors, climate activists, and the public for companies to disclose climate change risks are rapidly increasing. Since responding to climate change issues will affect corporate reputations among business partners and financial markets, Japan's leading companies have set ambitious 30-year targets and are taking climate change measures sooner than the government.

Moving Toward Carbon Neutrality

Global Japanese companies are at the forefront of addressing climate change issues at home. They are subject to a variety of regulations in other countries and must report on their global emissions. They may find that their CO2 emissions are relatively higher in Japan than elsewhere and thus represent a good target for emission reduction.

Meanwhile, an increasing number of Japanese institutional investors are participating in international climate change-related initiatives such as the UN-convened Net-Zero Asset Owner Alliance and the private Net-Zero Asset Manager Initiative. And they are using information from corporate disclosures to exercise their voting rights and push for carbon neutrality through engagement with their portfolio companies. Such efforts include shareholder resolutions on climate change.[9]

Leading companies in both the manufacturing sector and the financial sector are undertaking significant initiatives towards carbon neutrality in Japan. On the finance side, this includes a significant increase in green financing—both sustainability-linked loans and ESG bonds.[10] An important challenge for Japan is spreading these new best practices beyond the leading global companies. How quickly and to what extent will these new pressures for measures to address climate change also be reflected in the actions of smaller, "average" Japanese companies?

Taking Stock

Japan has recently made significant progress on ESG issues, particularly on climate change. The process was characterized by an important role for the government-related GPIF, government coordination with industry to adopt international TCFD recommendations on climate change, new pressures from domestic institutional investors and general acceptance by industry of the necessity to undertake corporate action. The transition is underway from soft law requirements for climate change disclosures to hard law obligations for Prime Market and other listed companies. This should be an important step to help spread best practices to smaller non-listed companies. It is somewhat difficult to assess the results of the policies outlined above since they are all recent developments. However, the overall positive response of leading Japanese companies and investors bodes well for the future.

Difficult challenges remain. Like many Asia-Pacific countries, Japan faces the daunting task of formulating and implementing a realistic plan to achieve the stated goal of net-zero carbon emissions by 2050 in a country that remains dependent on fossil fuels. It also faces the broader challenge of translating recent changes in corporate governance structure into more effective governance, both in general and on sustainability issues. Can the "G" be improved to match the "E" on ESG issues?

Notes

[1] For the current version, see THE COUNCIL OF EXPERTS ON THE STEWARDSHIP CODE, Principles for Responsible Institutional Investors, "Japan's Stewardship Code" — To promote sustainable growth of companies through investment and dialogue (March 24, 2020).

[2] For the current version, see TOKYO STOCK EXCHANGE, INC., Japan's Corporate Governance Code: Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term (June 11, 2021).

[3] The GPIF manages and invests reserve funds of government pension plans. It was established by the Japanese government (and remains under the jurisdiction of the Ministry of Health, Labor and Welfare), but operates independently under a board of governors who are experts in finance, economics, investment and management. It has strongly supported Japan's Stewardship Code and ESG-related measures. As it entrusts the management of funds to a significant number of external managers, such as trust banks, its policies exert strong influence over the policies and practices of asset managers in Japan (and, indirectly, their portfolio companies). See generally https://www.gpif.go.jp/. As of year-end 2021, the total assets of the GPF were 199. 6 trillion yen (over 1.7 trillion US dollars). See GOVERNMENT PENSION INVESTMENT FUND, INVESTMENT RESULTS OF 3Q 2021, at 1.

[4] For GPIF's stewardship activities, see generally https://www.gpif.go.jp/en/investment/stewardship-activities.html; for its ESG-related investment activities, see generally https://www.gpif.go.jp/en/investment/esg/.

[5] The shareholding of domestic and foreign institutional investors (asset managers and asset owners) in the Nikkei 225 stocks was less than 1% in 1999, but exceeded 30% in 2020. Some companies in the Nikkei 225 have a shareholding ratio of more than 50%.(Quick Factset database).

[6] See GLOBAL SUSTAINABLE INVESTMENT ALLIANCE, GLOBAL SUSTAINABLE INVESTMENT REVIEW 2020 (2021) (Figure 3 and Figure 4, at 10).

[6] See GLOBAL SUSTAINABLE INVESTMENT ALLIANCE, GLOBAL SUSTAINABLE INVESTMENT REVIEW 2020 (2021) (Figure 3 and Figure 4, at 10).

[7] See the TCFD Consortium website.

[8] Id.

[9] Four environmental groups, including the Kyoto-based Climate Network, submitted a shareholder proposal on climate change measures to Mizuho Financial Group in 2020, garnering more than 30 percent support. In 2021, the same group submitted a shareholder proposal to Mitsubishi UFJ FG, asking the company to include in its articles of incorporation a management plan in line with the Paris Agreement, and garnered 23% support. Although the resolution id not pass, it garnered widespread attention and prompted the target companies to increase their efforts to combat climate change.

[10] See, e.g., the Green Finance Portal maintained by Japan's Ministry of the Environment and Financial Services Agency, "Report by the Expert Panel on Sustainable Finance" Announced (Aug. 31, 2021).

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