

The Role of Financial Institutions in the Creation of a Sustainable Society



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Sumitomo Mitsui Trust Group is a signatory to the “Principles for Financial Action towards a Sustainable Society,” drafted in October 2011. These principles set out guidelines on the responsibilities and roles of financial institutions, including banks, insurance, securities, and fund management companies, needed for the creation of a sustainable society. In November 2011, four chairpersons of working groups established by the Drafting Committee gathered to participate in the dialogue with stakeholders presented here. They engaged in a lively discussion on the significance and main points of the principles, their links to international initiatives and regional developments, and methods of managing their implementation.

Moderator: We are fortunate today to have gathered together the three of you, who have served as chairpersons of working groups established by the Drafting Committee for the “Principles for Financial Action towards a Sustainable Society.” I hope you will not hesitate to share your views in a frank and robust discussion.

1. Significance and Main Points of the Principles

First, what are these principles about? Taking into account the status of Japanese financial institutions, what kind of role do you think they will play going forward?

Platform for Prompting Change in Awareness among Japan’s Financial Institutions

Kawaguchi: To begin with, these principles were meant to serve as Japan’s version of the United Nations Principles for Responsible Investment (PRI). The focus of the PRI is

on investment management, as they were formulated to help institutional investors and financial institutions integrate consideration of ESG (Environmental, Social and Governance) issues into their investment decisions when investing in pension funds and fund management organizations. Consequently, it doesn’t really matter if not everyone signs up to the PRI. In Japan’s case, however, we wanted principles that all financial institutions would sign up to. The finance industry is so large that initially we thought it would be impossible to get all financial institutions to take part. However, because we have created a platform that incorporates all individual initiatives taken so far, I think it will provide impetus for a huge change in the thinking of those in the financial world who have previously not shown much concern for environmental issues.

Seki: Financial institutions are engaged in a wide variety of businesses, so there is no single organization that encompasses them all. This is why the convening of 25 financial institu-

tions*, covering diverse financial sectors over a one-year period to discuss and formulate shared targets, was groundbreaking. The principles are also hugely significant because they encourage other stakeholders to take part in joint action.

* When the Drafting Committee was established. Ultimately, a total of 36 financial institutions took part.

Takegahara: The excuse used until now has been that because finance has an intermediary function, those managing finance have claimed that they're in no position to change unless those who put up the money and those who use it express a willingness for such change. However, I think these Japanese principles are significant because everyone recognized that this is not the case.

□ **March 2011 Disaster Heightens Awareness of Sustainability**

Moderator: What is your take on the 12-month period it took to come up with the principles?

Takegahara: In the beginning, the discussion was a textbook abstract discussion, but following the disaster participants gradually came to realize that sustainability was their problem too.

Moderator: The March 2011 disaster had an impact on the evolution of initial talks on devising environmental principles into the concept of a sustainable society based on international standards for sustainability, didn't it?

Seki: Today, sustainability is the central concept of the Principles on Sustainable Insurance (PSI) being formulated by the United Nations Environment Programme (UNEP). They also contain a social element. The disaster probably did have an effect, but I think it was more a case of a consensus to follow the international trend.

Moderator: The definition of "sustainable" was a key point in the discussions.

Kawaguchi: Most participants saw "sustainable" as meaning the continuation of society as it is today, so I think there were many who didn't have a good understanding of its true meaning. But since the disaster, there has been a shift in the perception of everyday life as being rock-solid to it being something that is surprisingly brittle. I think that participants became aware that they had to take action in order to change the unsustainable aspects of society.

□ **Groundbreaking Preventive Principles**

Moderator: What are your views on the incorporation of preventive principles?

Seki: I think it is extremely significant that preventive principles, which call for preemptive measures that take account of the various potential risks that financial institutions foresee, are a dominant feature of the principles for action.

Moderator: Does the notion of preventive principles carry sufficient weight to alter the lending behavior of banks?

Takegahara: I believe that taking a good look at environmental risks, which lie behind balance sheets and profit and loss statements, to supplement financial data will ultimately lead to the elimination of financial losses. If understood in this way, preventive principles can be used for credit management and managing credit risk.

□ **Opportunity for New Financial Businesses**

Moderator: What are your thoughts on opportunities for new financial businesses?

Kawaguchi: With consumers demanding environmentally friendly products and services, companies have no choice but to make their businesses environmentally friendly. I get the feeling that financial institutions are encouraging this trend by offering environmentally friendly finance and other services.



Seki: These principles call for addressing not only environmental issues, but also social issues as part of an integrated approach. For example, even BOP businesses* engage in solving the problem of poverty from a business standpoint and not as an activity that makes a contribution to society. As seen here, business behavior is already changing, and I think that financial institutions also want to join in.

* Base of the Pyramid: A new business model that targets low income earners in developing countries with the expectation that it will help solve various social problems in such countries.

Takegahara: Those whose business is the environment managed to turn the environment, which had been a factor constraining economic growth, into a business opportunity. A financial market that is able to truly appreciate this will ultimately help businesses, since companies that have made great efforts should see their share prices rise automatically, insurance premiums fall, and bank interest decrease.

2. Sector-Based Guidelines

Moderator: Please outline the guidelines your committee drafted, their main points, and how you envisage they will be used.

Fund Management, Securities, and Investment Banking Guidelines

Kawaguchi: The focus of PRI is on asset management. But these guidelines cover the three areas of asset management, securities brokerage, and investment banking. They signal the need to build a framework for the provision of financial products that take ESG into consideration by all three. There are investment banks that create securities at the upstream end of the sector, securities companies that provide services for purchasing and selling securities in the midstream, and asset management companies that invest in securities at the downstream end.

The guidelines also apply the term “ESG issues” to issues relating to the environment, society, and governance. Because PRI specifies ESG as an indicator that investors should take notice of, the term ESG carries the most weight in today’s SRI world.

Moderator: What are your thoughts on the adoption of ESG in finance in Japan?



Seki: The insurance guidelines were written with a particular emphasis on risk. Life insurance companies, as well as non-life insurance companies, are huge institutional investors, and this is why it is important for the insurance sector to increasingly incorporate ESG.

Moderator: What was the view of the Deposit, Lending, and Lease Working Group regarding ESG?

Takegahara: Our working group, which covered the indirect finance sector, felt some resistance toward ESG. The emphasis of CSR varies according to country. In Europe, CSR is centered on employment and human rights, but in Japan companies talk about CSR in the context of the environment. Therefore, in the world of direct finance that reflects the preferences of Western investors, the adoption of ESG will meet with little resistance. However, the indirect finance sector that deals with Japanese businesses is not yet ready to discuss ESG. There are those who thought that it is premature to incorporate Western ideas as criteria for making their own lending decisions. However, because their corporate clients are putting out more and more ESG data, they will gradually have to turn their gaze closer to the direct finance sector.

Insurance Guidelines

Seki: Because I am engaged in the drafting of the Principles for Social Investment (PSI) guidelines currently being drawn up by the UNEP Finance Initiative, I made a deliberate effort to make the insurance guidelines consistent with the PSI, which will become international principles for insurance. The insurance sector itself carries risks, as seen in an increase in insurance claims stemming from natural disas-

ters caused by climate change. Insurance companies take on not only such environmental risks, but also various ESG-related risks, such as human rights. Consequently, how to provide solutions is a major challenge for them. As with the guidelines for the fund management, securities, and investment banking sectors, the insurance guidelines make it necessary to pay more attention to ESG.

Moderator: From the standpoint of ESG, for example, is collaboration between direct finance and insurance out of the question?

Seki: One way would be for insurance premiums to reflect ESG ratings. In my view, however, I think that insurance companies have a bigger role to play in making it easier for a company to get into a new line of business. For instance, when a company takes up the challenge of developing a new environmental business, they could provide a mechanism for hedging that risk. I think that good will come from adept engagement between business companies, financial institutions, and insurance companies.

Deposit, Lending, and Leasing Guidelines

Takegahara: We faced the major challenge of whether or not we could draw conclusions that could be applied to common guidelines for mega banks, regional financial

institutions, and leasing companies, all of which have different customer bases and engage in different activities. The conclusion we reached was to formulate guidelines that would direct us to manage our own loss risks by managing our customers' environmental risks through our intermediary function, and thus would lead to growth on both sides. If we rephrase the purpose of the guidelines in such abstract terms, both mega banks and banks that support regional small and medium-sized enterprises agreed that there was no difference in what they do. But when it came to setting out credit policy, some thought it was premature to incorporate the ideas of the principles into their credit policies because they would constrain their main line of business, while others were of the view that there should be explicit principles because they would encourage the growth of their customers, from which they could reap some benefit. There were also those that thought the principles were self-evident. Unfortunately, we still have further work to do on this.

ESG is Also Important for Life Insurance

Moderator: Will outstanding issues be covered by other guidelines? I think that ESG-related themes will impact strongly on non-life insurance, but what about life insurance?



Seki: They will be extremely important, particularly for social themes. The role of the life insurance industry is as a private-sector provider of solutions for problems related to the aging of society, health, medical care, and pensions. This has been included in the guidelines.

Kawaguchi: Pensions receive a great deal of attention, while not very much is given to life insurance. It is important that we keep an eye on the activities of life insurance companies, which collect and manage funds from throughout Japan on a monthly basis.

Seki: The life insurance industry has been taking part also on an association basis, so I think this will provide some momentum for speeding up industry efforts.

3. Links to International Initiatives and Regional Developments

Moderator: Please tell us about the links that these principles have with international initiatives, such as the UNEP FI, PRI, and the forthcoming PSI. Also, how will the principles be disseminated within Japan, especially in the regions?

Recognizing Their Global Relevance is Important

Takegahara: There are regional financial institutions that are engaged in preserving biodiversity, including protecting local forests and mountains—something that one can't possibly do in Tokyo. Some of these institutions are not aware of the significance of what they do. In other words, initiatives taken on a regional basis are not irrelevant to efforts taken on an international basis. I think it would be

great if these principles provided the opportunity for regional financial institutions to realize the significance of their own initiatives.

Seki: Today, it has become the norm for small and medium-sized regional businesses to have dealings overseas. Because the economy is no longer confined to Japan's geographical boundaries, every financial institution needs to think of things in a global context.

Steps are afoot to hold the Multi-Stakeholder Forum on Social Responsibility for a Sustainable Future*, not only in the main centers, but in the regions as well. It is important that regional financial institutions are also included in these discussions, where the principles will be one of the topics.

* Meetings at which various stakeholders, including business groups, consumer groups, labor unions, the financial sector, NPOs, NGOs, and the government, discuss the creation of a safe and secure sustainable society based on equitable representation. A report entitled "Collaborative Strategy Toward a Safe, Secure and Sustainable Future" was issued in March 2011.

Kawaguchi: There are many regional financial institutions engaged in good initiatives, although I think that they exclude ideas that can be applied to regions besides their own. If they first changed their approach and then utilized the resources available in their region, a variety of needs would come to light, and they would see that these actually have global relevance. If, for example, they adopted an ESG perspective toward property that they had previously regarded as merely a piece of vacant land, they might see it as a space that has value or it might prompt a rethink of their local asset portfolio.

Takegahara: On the one hand, there are financial institutions that try to undertake advanced initiatives, while on the other hand there are also many that haven't made such progress. Consequently, I think it would be a good idea to have some kind of mechanism that puts the spotlight on regional financial institutions pursuing excellent initiatives.

Kawaguchi: Regional financial institutions will change if they come to realize that society recognizes such initiatives, they make the local community happy, and they promote good business.

Moderator: Is it possible that since receiving recognition changes the mindset of regional financial institutions, initiatives taken by such institutions can transform society into a sustainable society?



4. Turning the Principles into Something of Substance

Moderator: At present, it is envisaged that there will be an organization with a three-tier structure comprising an annual general meeting attended by all signatories, a steering committee responsible for coordination, and working groups that will take over the different sets of guidelines. What are your thoughts on how you think this kind of structure should be used going forward?

□ Combining General Meetings and Road Shows

Kawaguchi: First, there should be an event for financial institutions that explains the principles and how they are to be used. It would also be a good idea to take a road show to regional centers. Next, at meetings held once yearly, examples of best practice for three (sets of) guidelines could be introduced and awards given to outstanding signatory institutions.

Takegahara: I think that establishing a regional version of the Multi-Stakeholder Forum on Social Responsibility for a Sustainable Future and cleverly combining that with a regional road show would prove interesting.

For example, there could be a rotating schedule, whereby it becomes your region's turn once every so many years. When your turn comes, the signatory institution hosting the meeting could work in cooperation with the local community. You could put together a program that takes regional examples that have gone well in a community context and puts them into a large corporation context. In that way, you could show the signatories that have come to your region how wonderful your region is.

Moderator: Do you think we'll reach a point in the future when institutions that have signed up to the principles will get involved in putting out policy?

Seki: Looking ahead, I'd like to see activities where ideas that evolve through discussions held at meetings of various types of businesses are recommended as policy. But first I think it important that there are activities that raise awareness among ordinary bank, securities, and insurance sector workers so that they can learn what they can do as part of their own work.



Moderator: Meanwhile, I wonder if it's also possible that the public will criticize financial institutions by saying it is merely lip service.

Kawaguchi: There's no doubt that a company should not rest on its laurels once it has signed up to the principles, and that signing is just the beginning. It would probably be a good idea to establish a forum for gathering opinions from stakeholders and incorporate them when the principles come up for review.

□ In conclusion

Moderator: Even though those in the financial mainstream know that international society is moving in a direction that places emphasis on ESG, in reality they go no further than that. There is a danger that Japan's financial sector will be irrevocably left behind. As individuals who have chaired working groups and have therefore been in a position to formulate principles, our role, in addition to making such principles more widely known, is to work toward creating an effective framework for their implementation. As the first generation, let's do all that we can.

Note: The entire discussion (in Japanese) is available on the Group's website as a PDF file and as a video. (<http://smth.jp/csr/index.html>)