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Rates volatility and BOJ policy change plague Japan's SSA issuers

Japan's leading government-backed bond issuers had to stay on their toes and come up with novel ways to tap investors when faced with unprecedented volatility globally and in the domestic yen market over the past year. Whether it was switching to short tenor bonds in different currencies, including ESG labels on deals, or squeezing through narrow issuance windows as they opened, the SSAs left no stone unturned in accessing funding and staying attuned to investors' needs.

GlobalCapital brought together a group of Japan's top SSA issuers for a roundtable in late-March 2023 to talk about how they navigated the turbulence of the past 12 months – and how they are preparing to tackle further market turmoil.

Participants in the roundtable were:

Takahiro Ando, director, finance department, Japan Finance Organization for Municipalities (JFM)

Masahiro Ito, director, Japan Bank for International Cooperation (JBIC)

Shingo Kanatani, director, Development Bank of Japan (DBJ)

Kazumichi Saga, director, bond section, budget division, bureau of finance, Tokyo Metropolitan Government (TMG)

Junko Takahashi, senior director, budget for finance and investment account, and capital markets division, treasury, finance accounting department, Japan International Cooperation Agency (JICA)

Masanori Kazama, executive director, international debt capital markets, Nomura Securities

Rashmi Kumar, moderator, *GlobalCapital*

GlobalCapital: Let's start by taking a look back at your funding plans over the last 12 months. The world was gripped by uncertainty and international, and Japan's domestic, debt markets suffered. How did you navigate this?

Masahiro Ito, Japan Bank for International Cooperation: The market has been very different and difficult compared to what we used to see in previous years. However, as JBIC has a significant amount of funding needs in non-yen currencies especially in US dollars, we need to expose ourselves to the market both in good times and bad times. Therefore, we carefully listened to the voices of investors, took a very close look at market conditions and responded accordingly.

Over the last 12 months, we have done 100-plus meetings with investors, both face-to-face and online. The question is always about when to go into the market and what we are going to print and, fortunately, I think we've been successful in making the right choices. In May 2022, we issued euro-denominated government guaranteed bonds for the first time in 18 years, and following that success, we issued another one in February 2023.

This fiscal year 2022 had been challenging as we had to be extra careful in choosing the right timing, the right product, the right tenor, and the right rate. I am proud to say that my team members did a great job in this, issuing over $8bn worth of funding in total.

Takahiro Ando, Japan Finance Organization for Municipalities: The past 12 months were difficult compared to the prior year as market conditions changed suddenly. JFM issues bonds domestically and offshore international bonds.

As far as domestic bonds are concerned, since around July last year, spreads between JFM's domestic bonds and municipal bonds have widened. Around April 2022, the spread with the domestic bonds was 6bp, but then it widened to 12bp around July, and then it hovered around 20bp toward the year end, before widening further to 29bp.

For investors, it was difficult to grasp the right timing to purchase bonds amid such adverse market conditions. However, what became clear as a result was that we were able to identify who our strongest investors were. We are an organization set up by local governments, and we fund local governments, so we saw greater local government investment in our bonds although conditions were tough. That was positive. Our domestic funding plan was for ¥1.2tr ($9bn), and despite difficult conditions, it was successfully funded.

In terms of global issuance, we sell international bonds three times every year. In the spring of 2022, we did have a funding plan, but because of the Ukrainian war, it was very difficult to attract investors. Usually, we do a deal in the spring, but last year we skipped the spring deal.

On the other hand, in the summertime, around August and September, we were able to sell a €1.25bn five year bond. Our global funding is usually around ¥300bn a year, so €1.25bn in yen terms is about ¥180bn. So, with the yen depreciating, we were able to take advantage of cheap yen. In April last year, our first choice had been to sell a five year dollar denominated bond. But then dollar was rather difficult to issue in – we couldn't easily get the demand we wanted and the spread was high due to volatility. So instead of three times, we issued just two times in fiscal 2022, both in euro. We would like to go back to issuing US dollar bonds but the current situation is quite uncertain.

In terms of issuance this calendar year, we sold a green euro bond to appeal to investors there as a green bond issuer, which was positive.

Shingo Kanatani, Development Bank of Japan: We planned to carry out our fundraising plan for the 2022 financial year as quickly as possible in highly volatile markets. Things largely went as expected, both domestically and internationally. To adapt to this challenging environment, we executed our fundraising in the most flexible way in terms of issue timing, issue currency and size. Fortunately, we saw good demand from global investors for our international bonds issued in financial year 2022. This is partly due to Japan's low geopolitical risk and high standing. But this is also because, compared with international SSA names with AAA or AA ratings, spreads for Japanese SSA names are more favourable to investors in this interest rate hike environment.

Kazumichi Saga, Tokyo Metropolitan Government: Fiscal year 2022 has been a challenging year for TMG to issue bonds as we saw a deterioration in demand for domestic municipal bonds, in addition to unstable overseas market conditions. Even in such a situation, we increased the issuance size of our medium-term bonds in the domestic market and modified the maturity of our international bonds. By having a flexible and agile issuance operation with investor demand and other factors in consideration, we were able to raise funds steadily.

Junko Takahashi, JICA: As we are an ODA [official development assistance] agency, demand for our support rises when global situations become unstable from certain crises or when financial risks rise. For example, just recently, due to the earthquake in Turkey, we sent an emergency team there and now we are looking at how to programme our technical and financial assistance in recovery and rebuilding from the damage. Looking further back, for the last 10 to 12 months, we continued our Covid-related financial assistance to strengthen health systems in many countries. The Ukraine crisis and the food and energy crisis associated with it, and the global hike in interest rates triggered vulnerabilities and debt sustainability concerns in developing countries, so a number of programmes were formulated for our financial and technical support. Besides these, our loans and investments in developing countries for large infrastructure projects have been progressing well, with physical work catching up from setbacks during Covid. We are seeing record high disbursements for loans and investments this year.

Junko Takahashi
Japan International Cooperation Agency (JICA)

On the funding side, 2022 was a busy year. To meet our operational demand, we had to increase our budget plan in the middle of the fiscal year. We aimed to achieve stable funding through diversification and enlargement of our investor pool.

One strategy was to issue a theme bond from the start. We issued a ¥24bn Peacebuilding Bond in July in the domestic market. We chose this theme thinking it was a timely topic after the Ukrainian crisis occurred a few months back, but we targeted to allocate the bond proceeds to our projects around the world that are contributing to peace and stability, and reconstruction.

We drew attention to the fact that the number of conflicts around the world hit a record high of 56 in 2020, and refugees exceeded 100m in 2022. This theme also drew attention from the financial market offshore, and we received a lot of inquiries after the issuance.

We also maintained our focus on contributing to the development of the ESG market. We continued engagement with investors to attract interest to our social bonds, and we sold ¥800bn worth of yen bonds domestically. A portion was also targeted for retail bonds, and we found profound interest from both institutional and retail investors, especially the younger generations.

For foreign currency-denominated bonds in fiscal 2022, we faced high volatility and shortened the tenor of our bonds. Our preference is usually to issue longer tenor bonds like 10 years as our loan and investments have long terms, but we decided to go for five years. A $900m dollar denominated bond, which is the highest amount so far for JICA, was issued in May amid high market volatility.

In addition, I would like to touch upon your question about what kind of response we received from foreign investors. JICA is tasked to implement the Japanese government's ODA. Our social importance and mission resonate with investors fairly easily. And despite the financial risks, since we are a government affiliated organisation, and because we have a relatively high equity ratio, we were viewed positively and perceived as having a financially stable operation base by the investors.

Also, we would like to note that JICA's active assistance along with other development partners contributes to stabilising the economy of developing countries, especially in times of crisis, and indirectly helps to deter global financial risks originating from emerging markets.

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due 2025

May 2022
EUR 1,000,000,000
1.500% Guaranteed Bonds
due 2029

Sep 2022
USD 1,500,000,000
3.875% Guaranteed Bonds
due 2025

Sep 2022
USD 500,000,000
4.375% Guaranteed Bonds
(Green) due 2027

Jan 2023
USD 2,500,000,000
4.250% Guaranteed Bonds
due 2026

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EUR 1,000,000,000
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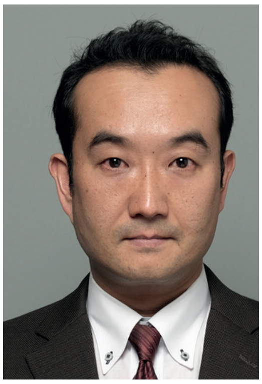
Masanori Kazama, Nomura Securities: The market environment has been difficult in the past year and global issuance volumes from Japanese issuers have fallen. With the rising interest rate environment remaining for longer, we have seen issuers going for a shortening of tenor.

GlobalCapital: Ito, in your face-to-face meetings with investors, what kinds of questions did you have to tackle? What were investors most concerned about?



Masahiro Ito
Japan Bank for International Cooperation (JBIC)

Ito, JBIC: We feel that investors were quite keen to hear about our ESG activities both for the lending side and the funding side, that is, plans to issue green bonds on a regular basis. For ESG activities, we provided comprehensive explanation as to what type of green projects we have provided finance to, and also the details of our ESG policy together with our green bond framework, both of which we announced in 2021.

Other than ESG, we received a number of questions with regards to our funding plans for the coming fiscal year, in terms of the amount, currency and tenor and. We also received some questions with regards to BOJ's monetary policy especially in the latter half of the year. However, since most of our assets and liabilities are in non-yen currencies, we had to explain that there is no material impact to JBIC from BOJ's policy.

GlobalCapital: Japanese SSA borrowers can perhaps be expected to benefit from global uncertainty, given the relatively low geopolitical risk and the country's high standing among international investors. Have you experienced that in the past year?

Ito, JBIC: Since JBIC has a broad lending base, which includes outstanding loans to Russia before its invasion of Ukraine, we were sometimes asked by the investors about those loans. But generally, we feel that the bonds issued by Japanese SSA issuers are viewed as safe assets by many investors. We were helped by that and were able to achieve successful transactions. Japan is rated single-A, but even so, we are grateful that many investors found quality with Japanese bonds.

On pricing, it's hard to quantify how many basis points of tightening we achieved from the quality of Japanese bonds, but all our issuances were well oversubscribed. Thanks to strong support from the investors, we even saw more than three times oversubscription in some of the transactions.

Ando, JFM: Our global issuance amounts are smaller compared to JBIC, but even so, international investors have become more familiar with our organisation. Our funding is solely for local governments in Japan, which is reassuring for them. Investors have been looking at our reports quite meticulously and they are reassured about us and recognise us as a Japanese SSA. We tend to issue standard benchmark $1bn deals. And in the two deals we sold in fiscal year 2022, we had demand of over $3bn equivalent, which was very strong. Our euro denominated funding is all converted into Japanese yen, so looking at the currency, our funding is converted from euro to dollar and dollar to the yen. Last fiscal year, the cost rose because of the cross-currency swaps, but it wasn't due to any negative reaction to our name.

Kazama, Nomura: The JFM name is already very well recognised by investors in Europe. With regards to potential benefits for Japanese issuers tapping global investors, cost tightening was not necessarily the case last year due to Russia's aggression in Ukraine. But compared to SSAs in Europe, Japanese SSAs are quite far away from Russia which helped from a European investor point of view. Feedback suggested that international investors find it easier to invest in a Japanese name.

Saga, TMG: When we visited Europe last fall, we heard comments from several international investors appraising Japan's economic and political stability. We recognize that such recognition is linked to the relative high credit of Japanese SSA issuers.

GlobalCapital: The dollar and euro markets are clearly important offshore funding markets for Japanese borrowers. What are your issuance plans for the new financial year and what currency mix are you looking at?

Saga, TMG: For the new fiscal year, we plan to raise a total of about ¥520bn from bonds, slightly lower than the previous fiscal year.

Out of this amount, more than 80% will be yen-denominated domestic bonds. For domestic bonds, we made a plan emphasising greater flexibility in order to allow us to select the optimal maturity and timing according to market conditions, in addition to focusing on our monthly issuance of 10 year bonds. For international bonds, we have issued approximately ¥65bn equivalent in the 2022 fiscal year, and we plan to issue a similar amount in the new fiscal year.

Kanatani, DBJ: The funding plan for fiscal year 2023 is basically the same as that for fiscal year 2022. We plan to issue both government-guaranteed bonds and non-guaranteed bonds domestically and internationally. In the domestic market, DBJ is one of the largest bond issuers. We issue non-guaranteed domestic bonds every quarter, mainly in three year, five year and 10 year tenors. Also, we issue government-guaranteed bonds in various tenors ranging from two years to 40 years. Internationally, we access capital markets with four major products including government guaranteed bonds, dollar sustainability bonds, euro sustainability bonds, and pound sterling non-guaranteed bonds on a regular basis. Currently, we plan to issue these four products in the 2023 financial year.

Uncertainty and volatility in debt capital markets will probably continue, both internationally and domestically, and therefore we will try to execute our funding plan in the most flexible way in terms of issue timing, issue currency and issue size.

Ando, JFM: For fiscal 2023, we would like to raise funds three times, like every year. The amount will be ¥300bn, which is also the same as every year. But we may deviate from the planned amount if necessary. For example, a year ago, we increased the amount by 20% to ¥350bn. And in the 2021 fiscal year with Covid-19, we increased to ¥600bn or so. If the market environment allows, then we are willing to issue a greater amount than the planned ¥300bn. In fiscal 2022, we only sold euro bonds; we did not issue any dollar denominated bonds. Therefore, in fiscal 2023, we would like to issue dollar denominated bonds in a full-fledged manner. But we do not have a specific plan as to which of the three times we shall issue in dollars. When the environment is right, we would like to issue the right product.

Ito, JBIC: In the coming fiscal year, we will continue to issue government guaranteed bonds. For fiscal year 2023 which [started in April], we have a budget of approximately $13bn, and this being the maximum, we aim to provide sufficient liquidity to the market as a Japanese SSA issuer. As for currency, 90% of our assets are in dollars, so dollars will remain the main currency for the issuance.

However it's difficult to predict how the dollar market will behave in the coming year. Under such circumstances, we may need to consider another option, which is euro denominated bonds. Fortunately, in the fiscal year 2022, we issued euro denominated bonds twice and expanded our investor base. Euro denominated bonds can possibly be issued on a regular basis so euro investors will have an opportunity to recognize and look into our name more frequently.

As for other currencies, for example Canadian dollars, Australian dollars or Sterling, we sometimes lend or have projects in the pipeline for these currencies. So if there is funding need, we can issue bonds in these currencies with government guarantees. In 2013 we issued in CAD and in 2014 and 2021, we issued in GBP, all of which, of course, were government guaranteed, just like our dollar or euro bonds.

Takahashi, JICA: The majority of our lending has traditionally been done in Japanese yen. But nowadays, an increasing portion of our loan portfolio for ODA or for private sector finance is denominated in dollars. So, our yen and dollar based funding shall continue, but we are expanding our dollar funding. To increase liquidity and get our name across, we would like to continue selling international bonds and engage actively with overseas investors. In the past, we've issued around the size of $500m or so in dollars up till last year when we did $900m, which is still relatively small.

We would now like to boost the size to over $1bn. Our issuances were non-labelled for our government guaranteed bonds until now, but we want to add a ESG label on our government guaranteed bonds as well. We have prepared a new social/sustainability bond framework aligned with ICMA principles to cover funding for our diversified portfolio. In this we are showing that all our projects have social impact across all sectors, but some have both social and green impact. So depending on market conditions, we would look to issue either social or sustainability bonds for the next overseas issuance, around $1bn to $1.5bn. Domestically, we plan to raise around ¥80bn in the same format.

GlobalCapital: What is your outlook for volumes and issuance conditions for Japanese SSA issuers in the year ahead? What challenges are they likely to face?

Saga, TMG: There is a lot of attention being put on the exit strategy of current monetary policy, both in Japan and abroad. In particular, due to the change of the governor of the Bank of Japan, there has been increasing interest in Japan's monetary policy more than ever before.

As for the domestic municipal bond market, it has been relatively stable over the past few years; nonetheless, we believe that it is necessary to conduct a flexible bond issue operation management by closely monitoring market environment in the new financial year.

Kazumichi Saga
Tokyo Metropolitan Government (TMG)

While international investors say they have no major concerns about Japanese SSA names, we have heard that they have concerns about the uncertainty of market trends and monetary policy after the BOJ governor's change, as well as about Japan's debt burden.

In response to these concerns, we will continue to emphasize our creditworthiness and fiscal soundness, including the fact that S&P rated us above the Japan country level rating in its stand-alone credit profile, and our tax revenues have steadily increased again after a temporary decline during the pandemic.

Kazama, Nomura: The SSAs in this panel have talked about how much they are looking to raise in the year ahead. In some cases, the amounts appear larger than usual because of the inflated yen, and in some cases roughly flat, but importantly everyone is looking to be as flexible as possible given volatile market conditions.

Last year, we saw many deals but the deals had to be restricted to specific, short windows, meaning issuers competed with each within those short windows to issue bonds. The same trend will continue this year.

GlobalCapital: Will the funding opportunities be limited to just dollars and euros?

Kazama, Nomura: From what I'm hearing so far, funding in other currencies can be cumbersome. Issuers tend to focus on markets where bigger funding amount is possible, which would mean US dollars or euros. These are the main markets. But if there is relevant funding need, issuers can look at other currencies too. Here, it will come down to what currency is most beneficial from a cost point of view when you convert it into yen. In such situations, it is possible issuers may want to tap other currencies for the cost benefits. But at the moment, there are not a lot of markets with that potential.

GlobalCapital: What is your view on the Bank of Japan's monetary policy and the doubling of the policy ceiling implemented in December? How has the ensuing volatility in yields and possibility of more policy tweaks expected to impact your funding plans?

Ando, JFM: The BOJ's yield curve control (YCC) has a major impact on the domestic market. The YCC ceiling was doubled in December, but despite the rise, interest rates are concentrated around 0.5% with YCC. They're still suppressed, but with the base rate doubled, the spread has widened. The rates at which bonds are issued have risen. In December, our 10 year bond yield was 0.55% before the BOJ change, but in January, it surged to 0.8%. As far as funding cost is concerned, there has been a major impact because of the change in BOJ's policy on the yield curve cap.

Can there be more hikes because inflation is still there? Investors are waiting and seeing. While the yield ceiling has been frozen, things did not change all that much. Our costs are rising but we're not able to gather demand. So from an issuer point of view, it's a pretty unstable situation.

So what's the outlook? There' a lot of speculation: will the BOJ raise YCC ceiling rates from 50bp to 100bp, or will they lift YCC all together? There will be such debates happening at some point in the future. The new financial year [started] in April, but there is uncertainty over whether the BOJ will change its policy. At the same time, demand is tough. Usually, there's rising demand early in the new fiscal year, but this time, investors prefer to wait and see so it's difficult to collect or increase demand for our bonds. If there's more predictability, it will be easier for investors to take action but it's inconceivable that the BOJ will announce any changes to YCC policy beforehand.

Takahashi, JICA: It is probably safe to say that the market expects that interest rates are likely to go up eventually, but the timing is up for debate and therefore investors are waiting to see. In such an unstable market situation, we are concerned that issuers may not generate enough demand even if a wider spread was attached.

Looking back, towards the end of the year, the situation became increasingly difficult even for us. JICA keeps a minimum and relatively stable size of issuance in yen bonds, but we do have increasing funding needs, so we need to keep our options open to be able to issue a larger amount in Japanese yen denominated bonds if needed. In 2022, we made a quick additional issuance at the end of the fiscal year, but we adjusted with a very short tenor to make the issuance more attractive and achieve our target size. For fiscal 2023, we continue to feel the need to select the tenor appropriately and keep a close eye on investors' preference.

Kazama, Nomura: Everyone is watching to see when the Japanese yen interest rate will rise and when it will trend down. The BOJ governor [changed in mid-April] so in the immediate future, it doesn't seem like there would be dramatic policy changes but in April the BOJ will hold a meeting to decide on the policy rate. We would like to see clear guidance from the BOJ to offer visibility for the market and for investors. This will be conducive for investor sentiment.

Shingo Kanatani,
Development Bank of Japan (DBJ)

Kanatani, DBJ: Haruhiko Kuroda, the [previous] BOJ governor, widened the 10-year yield target band in December with the aim of a better functioning market. Unfortunately, BOJ has failed in achieving that goal. Now, the majority of market participants expect Kazuo Ueda, the new incoming governor, to probably change monetary policy by June. In any case, domestic investors are carefully watching BOJ's stance and if something surprising happens, that could have negative impact on our domestic fundraising to a greater or lesser degree in the very short term.

In the longer term, a change of BOJ's monetary policy and subsequent yield curve upward movement could have both positive and negative impact on our fundraising. Some investors will decrease exposure to fixed income investments to deal with losses in their existing portfolio. Some investors will show a positive response to a yield increase. And some other investors will change their preference in terms of bond maturity. We will try to carefully monitor market dynamism and adjust our funding strategy accordingly.

GlobalCapital: Let's move on to ESG. What are your expectations for Japan's ESG bond market, in terms of volumes and innovation?

Kazama, Nomura: The majority of Japan's SSAs have been issuing labelled bonds in the international space. While we may not see a big spike in volumes, a shift to different currencies may be highly possible. As for use of proceeds, issuers are quite restrained. In addition, SSAs and other issuers of labelled bonds face some challenges around disclosures. Huge volumes of data and information concerning ESG have to be disclosed, so issuers are burdened with additional disclosure requirements.

At the same time, many environmental organisations are pointing out weaknesses and loopholes in ESG related disclosures, making the issuance environment rather tricky. Yet, within Japan, ESG issuance is increasingly exciting, including in US dollar or euros. We have seen ESG issuance consistently increasing from Japan, despite the decline in the global market.

Kanatani, DBJ: The key development in Japan's ESG market in recent years is a wave of transition bond issuances from a wide range of industries. The long-term transition strategies of issuers are consistent with the Japanese government's roadmaps of respective industries' greenhouse gas emission reduction scenarios toward 2050. This wave shows the increasing importance of transition finance in Japan.

The issuance of transition bonds from the Japanese government planned in FY2023 will probably have a big impact on Japan's ESG bond market, potentially further boosting the volume of domestic ESG bonds.

Saga, TMG: The Tokyo Metropolitan Government has diversified its financing methods by issuing ESG bonds to enhance environmental policies. Currently, ESG bond issuances by both governments and the private sector are increasing. We hope that this revitalization of the ESG bond market as a whole will lead to the achievement of major domestic goals, such as carbon neutrality in 2050.

GlobalCapital: As ESG bond issuers, what challenges have you faced? And where have you seen the most opportunities?

Ito, JBIC: Disclosure is something that we have to be highly conscious of. In Japan, the relevant authorities have taken actions to regulate and enrich ESG disclosure and requirements so that the Japanese standard will be aligned with the global standards. To meet those standards, we as an issuer will have to put in a certain amount of time and effort.

When we talk to green investors who specialise in buying green products like our green bonds, they are generally highly conscious of ESG-related matters in our activities, and are sometimes quite strict and stringent in the way they pose questions. In the past, coal fired power plants in developing countries, for example, were something we supported. Although we have already discontinued our support to new projects, we still have some outstanding loans for the existing projects. We need to explain to investors thoroughly and sincerely as to how we are handling these projects.

Furthermore, various efforts for energy transition are taking place in Southeast Asia and elsewhere in the world, that is, a transition from coal to gas or other cleaner sources of power such as renewable energy, and JBIC is in a position to support projects which lead to energy transition. That means for gas, which is one kind of fossil fuel, we would have to continue to provide some support while those countries are on their way to make transition but still have growing demand for power.

In JBIC's green bond framework, fossil fuel is clearly excluded from eligible use of proceeds funded by green bonds, so we would have to make the funds available by some other means. However, necessity to continue supporting such fossil fuel use for now is something we need to ask the investors to understand.

Ando, JFM: We have a global perspective as well as a domestic perspective, so we have to separate these two. Globally, regulation is being developed and we have to keep aligning ourselves with the latest regulations. What is unique for us is green bonds. We have been issuing green bonds since 2020 and have sold four of them so far. The first time we did a green deal, we worked very hard to set an example for local governments in Japan. We came up with this voluminous report with huge

Takahiro Ando
Japan Finance Organization for Municipalities (JFM)

amounts of data. Green bonds are now increasingly regulated but because we started off by being tough on ourselves, we haven't faced problems responding to regulation. And investors appreciate our report. They said it's very good and rated it quite highly. That's positive, but the negative aspect is the collection of data. It takes so much time to collect data that the number of bonds we can issue ends up being contained. It's a trade-off, if you will, because of the work you have to do in collecting data.

But of course, green bonds need to be issued in line with demand from investors. We need to look at demand from the investor base, the regulation, and reorganise the format of the report. By doing so, we may be able to increase the amount of green bonds. That is the direction we are heading as we look to increase the number and amount of our international green bonds.

When it comes to the domestic market, we have yet to issue ESG bonds. But local municipal green and sustainability bond issuance has been rising. On top of that, we will also see green transition bonds in the new fiscal year in the domestic market. Interest in ESG is rising quite a bit and we don't want to be behind the trend. We are considering issuing such bonds in the domestic market, but we don't have any specifics around that just yet.

Takahashi, JICA: Since 2016, all our domestic bonds have been labelled as social bonds. In that regard, we have been participating in the ESG market's development from the beginning and would like to think that we are one of the pioneers for the domestic market. Many other issuers have started to issue labelled bonds and there is rising interest in ESG — which we expect to continue going forward.

As mentioned earlier, we issued a Peacebuilding Bond in 2022, which is part of our social bond programme. As we have many diverse projects and activities in our portfolio, we focus on specific agendas/sectors which we think investors are interested in, and issue themed bonds — and the theme in the past year was peace building. For the moment, for Ukraine, we are mainly providing technical and grant assistance, which is sourced by our other financing accounts. So bond proceeds are allocated to projects aimed to support post-conflict rebuilding/reconstruction efforts in Iraq, the Philippines (Mindanao Islands), and in Africa and elsewhere, but the hope is that in the near future, such funding can be utilised to support those currently under conflict and struggle, including Ukraine for recovery.

We are looking to add sustainability bonds to our portfolio, as well as to label our bonds overseas. In general, we believe that all of JICA's bonds contribute to social impact but we have certain projects like clean energy, clean transportation and sustainable water usage, or climate adaptation measures against natural disasters such as flood control. But we haven't always labelled our bonds explicitly green, but we feel that it would be a good strategy for expanding our investor base by becoming more proactive in ESG labelled deals both domestically and internationally.

But when having conversations with investors regarding our approach for projects aimed at social or green impact, we realise the increasingly strong need to facilitate understating from investors about how difference in economic status or environmental context in developing countries affect priorities of the developing countries, and how that leads to the need to have different or flexible approaches to green compared to that of developed countries.

Transition, for instance, is more important for developing countries, and we try to clarify to investors what transition means for developing countries — what kind of transition plans do they have in place? How are they strategising in the long and mid-term to meet their Paris Agreement pledges? And how is JICA supporting them with its co-benefit policy towards countermeasures for climate change? As an ODA agency, we will continue to promote understanding by carefully disseminating accurate information.

Saga, TMG: The TMG currently issues yen green bonds for institutional investors and non yen-denominated green bonds for domestic individual investors, in addition to yen-denominated social bonds for institutional investors.

When issuing non yen bonds targeted to international institutional investors, it is important to secure sufficient eligible projects to satisfy the issuance size, which is usually a benchmark. In that respect, we believe this is a matter of concern since there is a limited number of issuers capable of having this many potential eligible projects.

GlobalCapital: Beyond what we have discussed, are there other hurdles to ESG issuance domestically or internationally?

Ando, JFM: We have been mainly talking about bonds so far. What we are also doing now at JFM is focusing on communicating on how we are tackling ESG as an organisation, specifically the number or the percentage of female board members or the amount of power usage around various offices. These pieces of information are being disclosed to investors. As a part of our ESG initiatives, we have to communicate fully to the market and the society that we are very close to ESG and tackling it on a continuous basis.

Ito, JBIC: When we talk about ESG, we tend to focus solely on the E, being friendly to the environment, but we have to look at the S and G, which are just as important. At JBIC, we launched last year an internal committee specialising in sustainability and an individual department specially engaged in ESG. Our own operations need to be friendly to the environment but that is not sufficient. We have to work on those projects that will cope with social issues, and at the same time have good governance within the organization. We have to gain investors' understanding and have an eloquent explanation of what needs to be done and what's being done in our organization.

As the team responsible for funding for JBIC, this would be something which needs to be taken into account when we go into the market.

Takahashi, JICA: Talking with investors during the roadshow, I also felt that investors are shifting more of their attention to the issuer's ESG management. It's increasingly important not only to show transparency in allocation and use of proceeds of the bonds, but also for the issuers to prove themselves to be ESG worthy. Although we believe that JICA is advanced in this respect, we will constantly try to improve ourselves and our communications to investors.

However, although I am in support of the good intensions and the need for a certain rule for governing the growing ESG market, I personally feel a bit watchful about the rapid shift towards reliance on external ESG ratings, and extensive disclosure needs or the risks that are accompanied with it. As an issuer, we have responsibility to articulate our policies and actions in a transparent manner to our investors. More investors have started to rely on external ESG scorings by ESG rating companies, but these can be unsolicited ratings, evaluated without the issuer's knowledge. Evaluation results can be based on limited public information and methodologies by the rating companies may not be disclosed in many cases. Transparency should be improved in both directions.

I hope that stringent regulations would not become a disincentive for companies to get involved in ESG investment and issuance and hope for a healthy and sustainable development of the ESG market.

Saga, TMG: As the volume of ESG bonds increases, we believe it is important for each issuer to create an environment in which investors can purchase ESG bonds with confidence by conducting transparent reporting and obtaining external reviews.

In January 2023, TMG prepared a new impact report and became the first municipality in Japan to obtain an external review after issuing ESG bonds. Going forward, we will continue to conduct high-quality bond issues with transparency and objectivity and contribute to the development of the domestic ESG bond market.

Masanori Kazama
Nomura Securities

Kazama, Nomura: ESG rules are important and what we see is that rules are inconsistent globally. We need uniform rules to identify clearly what is green and what is not green. Some consensus is necessary. There are some investors that demand a certain ESG rating, for example, but some flexibility in mindset is needed to see who is eligible and who is not. It is also the responsibility of the underwriters to communicate this clearly with the market. GC

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Japan's transition debt market: bumpy but blossoming

Japanese issuers and investors have been eagerly embracing transition financing as a way to help meet the nation's climate and emissions goals, with the government too making big strides with its ESG roadmaps. Greenwashing concerns are rampant, however, which the regulators are attempting to tackle by demanding more disclosures from both issuers and investors.

GlobalCapital brought together a group of ESG specialists for a roundtable in late March 2023 to talk about the latest developments in the country's ESG market, the challenges ahead, and how transition financing will be critical for Japan.

Participants in the roundtable were:

Teppei Yamaga, managing director, head of net zero strategy department, Nomura Asset Management Co

Natsuki Iida, sustainable equity analyst, Schroder Investment Management (Japan)

Kanedome Masato, principal, sustainability service group, DNV Business Assurance Japan KK

Kazuyuki Aihara, senior officer, head of sustainable finance products, sustainable finance, Nomura Securities

Rashmi Kumar, moderator, *GlobalCapital*

GlobalCapital: Japan is one of the global leaders on ESG, with its ESG financing market seeing significant growth and sophistication in recent years. What are some of the latest themes and trends in Japan's ESG bond market?

Teppei Yamaga, Nomura Asset Management Co: ESG bonds have gone beyond just green bonds to blue bonds, social bonds and transition bonds. Interest has been rising specifically for transition bonds as investors start divesting from large emitting companies. Increasingly, investors are providing funds to sectors and companies that are working at reducing greenhouse gas emissions from their businesses, so understanding has risen for the need for that. I'm responsible for both equities and bonds at Nomura Asset Management. On the equity side, ESG investment is essentially with secondary transactions, so it's not that funds go directly to the issuer; they go to investors. Therefore, engagement and proxy voting are more important in equity investing. But in the case of bonds, most of the transactions are primary. The funds that are raised will go directly to the issuer and in that regard, bonds are important for capital investment and other financing.

In terms of its position in the market, green, sustainability, social and transition bonds are being vigorously promoted by the government of Japan. Guidelines and roadmaps are being developed around things like providing subsidies for the cost of fundraising for transition bonds or how different sectors can move toward net zero. Therefore, they have been contributing to the expansion of the transition bond market in Japan. Also, when you talk about transition, how are you going to change your business model so you can have innovation in the future? How can investors evaluate that? That's very difficult to evaluate so there will be increasing requirements for measures and metrics on how companies disclose information.

Natsuki Iida, Schroder Investment Management (Japan): We are a European investor in Japan, a market that is paying a lot of attention to ESG and is evolving. Positive-ESG companies, such as companies with higher ESG rating, initially got more attention. But I see that the delta of change is getting more important. In other words, the key question is how a company is trying to mitigate short- and long-term risks and to adopt to changes.

This is particularly true for climate change, which I think is one of the three key themes in Japan. It is critical for investors to understand if and how issuers contribute to the transition to a low carbon economy. We are very mindful that the situation varies among different countries and Japan has its own unique transition pathway. For us to better understand a company's efforts to decarbonization, we developed an Avoided Emissions framework with Singapore's sovereign wealth fund, GIC. For example, while the manufacturing of wind turbines is a very carbon-intensive process, wind power generation will be able to make a significant contribution to CO_2 emission reduction. Therefore, we need to understand the overall impact of companies and give credit to companies involved in such technologies or products.

The second key theme is human capital. Because of the structural demographic challenges in Japan, attracting and retaining the right talent is a material issue for all companies. Unlike environmental topics, quantitative analysis of human capital management comes with a challenge. We will need to combine both qualitative and quantitative elements when analysing human capital management. Despite those challenges, one of the exciting developments in Japan is that disclosure related to human capital management is becoming more readily available and increasingly sophisticated. We are also able to use alternative data such as employee review data from third-party databases. At Schroders, we have a proprietary tool called SustainEx. The tool enables us to understand a company's positive and negative externalities. In relation to human capital management, we can analyse externalities related to employee training and salaries using SustainEx.

The final theme is natural capital and biodiversity. Because of our economy's dependence on ecosystem services, we need to evaluate a company's exposure and risk management in relation to natural capital and biodiversity. The importance of forests is growing because they also serve as carbon sinks. For listed companies, we built a scorecard to understand exposure to and risk management of forest-related risks. On the private side, Schroders and Conservation International established Akaria Natural Capital last year to accelerate investment in natural climate solutions.

Kazuyuki Aihara, Nomura Securities: I work in the sustainable finance department of Nomura, so I work with issuers to support their financing and diversify into the ESG market. As mentioned by the others, there are many ESG themes in Japan and government bodies are working on everything from carbon reduction and net zero roadmaps to boosting transition financing. The Ministry of Economy, Trade and Industry (Meti), the Financial Services Agency and Ministry of Environment have aligned to form guidelines for transition finance. A roadmap for the auto industry, which is broad and includes many sub-contractors, has just also been formulated. Japan and China seem to be the only countries where transition financing issuance has been taking place. Globalization and the internationalization of transition financing is one of the major themes considered important by overseas investors.

In Japan, transition bonds are being planned by the government and the transition theme will become more recognised in the new fiscal year. The biodiversity theme is also important, and the TNFD [Taskforce on Nature-related Financial Disclosures] and biodiversity conservation are attracting keen interest by the Japanese government. Investment banks such as us are introducing green and blue bonds to potential issuers in Japan. We are surrounded by ocean, therefore, conservation of marine nature capital, natural resource and natural capital will be a major theme. Green and blue bonds will be a theme too.

Kanedome Masato, DNV Business Assurance Japan KK: We recognize that the overall trend is similar to that of the global market. The ESG finance market, which was initially centred on green bonds, is expanding to social and sustainability, and in addition to bonds, loans are also expanding. Furthermore, sustainability linked finance, which supports corporate initiatives and can be used by a wide range of fundraisers, is expanding.
In the past few years, many natural disasters that are said to be caused by climate change have occurred in Japan. In particular, through transition finance, it is important to promote the realization of an energy supply society that does not emit greenhouse gases in stages, due to the geographical conditions and the characteristics of the conventional industrial structure in Japan. The market is being understood, which I think is great. Currently, transition finance is mainly implemented by major companies in high-emission sectors, but in the future, it will be important for organizations in a wide range of industries and sizes to promote low-carbon and decarbonization using transition finance. To that end, it is essential that financial institutions lead the market as so-called enablers and play an active role.

GlobalCapital: What are your expectations for further growth and innovation in Japan's ESG debt market?

Kanedome Masato
DNV Business Assurance Japan KK

Masato, DNV: For green and transition bonds, the development of environmental technology through green innovation, led by the government, is important. This includes transition bonds, subsidies for green finance and transition finance, promotion of technology and financial support in an integrated manner. These are essential for accelerating social implementation, and we believe it will be the cornerstone for the expansion of the ESG market. In particular, as the shift to a green society using ESG bonds progresses in Japan, it can become a model of energy transition in Asia, where the use of fossil fuels is currently the main focus. It is expected that the progress of this development will contribute to the transition to low-carbon and decarbonized societies not only in Japan but also in Asia and the world.

In addition, regarding social bonds, there are cases where the widening of social disparities and social problems that have not become apparent so far are being highlighted more than ever. For this reason, instead of discussing and evaluating only the definitions of social issues that have been considered in the past, as an evaluation agency, we are always aware of the emergence of new social issues and respond flexibly. In any case, ESG bonds are a good opportunity for financial institutions, investors and fundraisers to consider what actions society as a whole needs to take for the environment and society, which are not limited to simply issuing bonds. It is expected that ESG efforts by the society will lead to the resolution of environmental and social issues.

Aihara, Nomura: Transition bonds, blue bonds and sustainable financing will all grow in the future. Also, there will be more and more equity based financing. There will be various products and financing tools that will be used by companies linked with ESG. Understanding among investors is also necessary as the presence of equity based ESG funding is still small. This is something we are keen to address.

Sustainable finance, conventionally was centred around bonds that were tied to the purpose of funding. It was clear, for example, with green bonds and social bonds, investors were reassured as to what they were buying, because the purpose of funding was clear. But if it's a common stock, it would be buried among all the other common stocks, so how can you tie that to a specific purpose of funding?

Yamaga, Nomura Asset Management: Japan's ESG debt market is growing rapidly. In the primary equity capital markets, we have seen some equity private placements and some convertible bonds issued from time to time, in addition to public offerings. You need a corporate story in your primary IR activities for the funds you have raised. Or if it's a secondary offer, then what is the growth story for the issuer down the road? The issuer has to explain that to investors. But when it comes to secondary ESG investment I think investors are increasingly keen on that. At the time of offering, when roadshows are held and when the corporate story is presented, issuers need to explain their ESG and sustainability strategies, and that is happening. As with debt financing, if it's public placements or a convertible bond, if ESG is the theme – like transition or a drastic change in the business – if the purpose of the funding is for that then I think such equity financing will continue to grow. As transition risks get higher, funding becomes crucial as a capital buffer for that. You need to increase capital adequacy. To do so, direct funding through equities and having an ESG flavour as part of that will increase in the Japanese market.

Iida, Schroder: I'm a sustainability equity analyst within the Japanese equity team. I mainly look at secondary transactions. What I have found is that among Japanese equities or Japanese companies, firms are increasingly interested in understanding how they are evaluated in terms of ESG. With ESG research and analytics getting more sophisticated, we are now more interested in not just the ratings or scores, but also how companies are trying to adopt to new trends and emerging challenges.

In Japan, there is a strong push to expand the ESG market by the government. Corporate governance reform took precedence and is still ongoing. Other areas such as transition finance are emerging as an important agenda for Japan. While there is a tailwind, we will need to address challenges such as greenwashing which is an important agenda for many regulators globally.

GlobalCapital: Is that something regulators or banks are working towards offering more transparency to the market?

Aihara, Nomura: Convertible bonds are one example of what is being done. For example, an elderly nursing home company running a home, if they issue equity, you can tie the use of proceeds to the firm's pure business. But if a firm has multiple business lines, you could issue equity that is tied to sustainability, but I don't think there's a way to do that because there's no way to tie the funds raised to the purpose of funding, which is sustainability. That is something that needs to be developed.

GlobalCapital: Japan's Financial Services Agency in April set limits on funds labelling themselves as ESG in an attempt to address concerns around greenwashing of funds pitched by financial institutions. The rules will kick into effect in April. What impact are these limits likely to have on your own ESG investment goals and targets? And what broader implications can the market see?

Natsuki Iida
Schroder Investment Management (Japan)

Iida, Schroder: In our firm, we have funds that are subject to sustainability-related regulations such as to the EU's SFDR [Sustainable Finance Disclosures Regulation]. Greenwashing is clearly one of the areas that is being addressed globally. As we learnt from the SFDR, investors will need more standardized disclosure from issuers so they can collate and disclose sustainability-related information at the fund level. In the EU, for example, the EU taxonomy will be the basis of the information disclosure though it is still work in progress. In Japan, we don't have a common language as to which activities should be considered sustainable. This could pose challenges from a disclosure perspective. The definition of ESG or sustainability still leaves ample room for interpretation, though this is not just a Japan specific issue.

Yamaga, Nomura Asset Management: We have offices in the EU and the UK, so we are taking action to comply with SFDR and SDR [Sustainability Disclosure Requirements] as opposed to just Japanese regulation. We take global perspectives and are learning from the EU or the UK, thereby being ahead of the rest in creating the necessary structure or placement of human resources and setting up appropriate teams. That is what we are doing.

We are one of the major investors in bonds like green or transition bonds that can be evaluated using ESG fund providers' data to provide future potential GHG emissions or temperature scores. We can gather such information from various providers; they are recognized evaluation methods and we can issue monthly reports using those metrics. We are quite proud that we are ahead of the rest of the market in Japan in doing these.

We have to comply with the new regulation in Japan, of course. The target and goal that we would have to meet is somewhat minor in the sense that we were taking proactive action before the issuance of these guidance from the regulator. The FSA gathers opinions from various investors and I understand there are some investors that have nothing to do with ESG but are selling some ESG labelled funds. The most recent rules from the FSA are just the starting point of guidelines to make sure that everyone issues funds that are truly ESG related.

The regulations and guideline are both positive and negative. When a new guideline is issued, there may be some cost burden on the part of those regulated, yet there is a benefit of increasing transparency. Also, since we're talking about investment, there are private retail investors who feel that ESG investment is within their reach. They may think if they invest in ESG funds, then they can indirectly create some impact on the society. For them, more transparency is beneficial. With these rules from the FSA, we are moving towards increasing transparency.

GlobalCapital: How can you balance the need for more ESG disclosures with reducing the tedious and expensive disclosure and information-gathering requirement for issuers?

Iida, Schroder: That is quite a good point. The reality is that disclosure will be costly to both investors and companies or issuers. It is cumbersome but this is a common issue that is recognized by the market. That's why the ISSB [International Sustainability Standards Board] and SSBJ [Sustainability Standards Board of Japan] have been focusing on that, to set standards for sustainability-related disclosures. That burden has to be lessened through a degree of standardization. What ESG issues are truly material would have to be scrutinized, as well as what will be most impactful disclosure to stakeholders. We are starting to see a bit more clarity on that in Japan as SSBJ has been trying to align with the ISSB recommendations. But there are different schools of thought when it comes to materiality. The US regulator has its own philosophy about how disclosures should be. When and where we shall land is something we have to watch carefully.

Yamaga, Nomura Asset Management: I agree that there are different schools of thought. What are ESG investments and ESG trust funds? From a societal aspect, we tend to think too much in one way. When you think of materiality in the market, the price will be set in relation to corporate value, but we tend to start by talking about what pieces of information should be disclosed in terms of sustainability regardless of the corporate value. The issues of climate change, natural capital and human capital are prerequisites in considering sustainability. These are major issues we have to be conscious of. Yet it's because of this focus on corporate value and materiality, we have disclosure regulations today.

From the viewpoint of investment, clearly share price or the bond price shall be impacted by certain pieces of information. The highest priority pieces of information should be disclosed in terms of impact on their prices. We haven't had a clear sorting out of these yet. The environment is only one of the main criteria for investment; ESG is an extra factor on top of the financial strength of the company. From the financial viewpoint, we have to consider what should be the specific items to be disclosed as needed by investors. If you have to talk about different sectors, it will be highly burdensome but it may have materiality.

We have to discuss this in detail, otherwise we would end up having to talk about all disclosures related with climate change, natural capital and human capital, and everything will go bust. There will be disagreements between issuers and investors and everyone will end up burdened with one task after another. My belief is that having distinct methods of measuring financial impact of ESG factors will not be possible if issuers cannot disclose information sufficiently. So I hope improvements are made.

Aihara, Nomura: Issuers are faced with increasing obligation and responsibility, which is a concern. The market has gone from conventional financing to sustainability financing and the introduction of new concepts like ESG. Within ESG financing and sustainability, introducing transparency and standardization are large themes to create market credibility. At this moment, we're in a transition phase where standardization and transparency need to take root.

GlobalCapital: How do you evaluate the ESG impact of an asset? What challenges are you facing around this – and how can we solve some of these issues?

Yamaga, Nomura Asset Management: There are many international guidelines that have been issued and their methodologies are referred to for impact measurement. When it comes to impact measurement and assessment, impact analysis tools are also being published. We reference them to measure impact rather than collecting information ourselves; we look at disclosures like sustainability reports and key performance indicators, based on which we disclose the impact created through our portfolio companies. My view is to look at all the impact in an aggregate for the whole portfolio but we're not investing in everything when it comes to a portfolio company. We look at the aggregate level based on investors' holdings. For example, for a $100m investment, how much impact is being caused? With the carbon footprint and intensity, for example, in terms of GHG emissions and if it's an active investment, there's a benchmark for how much impact is being made. When it comes to the specifics, we look at those against the benchmark. We also understand that impact management and measurement are important. We look at the positive and negative impacts; where there is negative impact, we pay attention to that and establish a system to deal with it.

When looking at corporate disclosures, we are trying to capture management developments as well. The problem is that the definition of ESG impact is sometimes subjective. There are different ESG data providers, but the concept may differ from one provider to another. Practically speaking, it's sometimes hard to look at them so international guidelines serve the best purpose.

Iida, Schroder: It is important that we separate our impact investing approach from how we evaluate ESG in general for our sustainable investing. For impact investing, we have the impact scorecard to assess and monitor the impact of investments. To give you an example as to how we measure impact, we analyse the amount of renewables capacity added throughout the holding period. We follow the IFC's Operating Principles for Impact Management.

For ESG analysis, we have a range of proprietary tools. I will give two tools as examples. The SustainEx model looks at the social value of externalities and turns externalities into dollar values. We have around 40 SustainEx metrics for public equity. Positive externalities can be something like if a company is offering living wage to employees, it is doing something beneficial to the society. If the employee's income exceeds fair wages, it will have a positive impact on the economy. Alcohol and tobacco are examples for negative externalities. Alcohol and tobacco are linked to potential health issues, and there are costs for dealing with diseases, so we allocate that to a company. We have recently launched a new tool called ThemEx, which aligns products and services of companies to sustainable investment themes or the UN Sustainable Development Goals.

GlobalCapital: Are investors putting too much focus on ESG scoring of companies?

Yamaga, Nomura Asset Management: We deal in both equities and bonds, so we have separate ESG scores for both because of the different nature of those two instruments. I do understand disclosure regulation has not been formulated in a fully-fledged manner yet, and the impact on the corporate value is unknown. For example, climate change is easy to understand – that any GHG emissions would result in a carbon tax or add impairment charges that would translate fairly easily for financial analysis. When it comes to natural capital or human capital, they can be potentially translated to financial analysis, but it's hard to actually do that. If you have quantitative analysis, we would have to have more in-depth analysis and disclosure.

Teppei Yamaga
Nomura Asset Management Co

Neither disclosure nor investor evaluation have gone to very in-depth levels yet. Conventional evaluation of the corporate value can be taken into consideration with that scoring. Having that kind of a scoring would facilitate understanding of the portfolio quantitatively and you can have a benchmark against competitors. So the scoring is a highly valid and effective evaluation method.

We tend to use a scoring based on the data issued, for examples in our own ESG scores for Japanese equities, we look at not just the volume of GHG emissions, but also the economic value by using our internal carbon price to identify the financial impact on cash flow and shareholders' equity of portfolio companies to evaluate their transition risk. All economic cost burdens of GHG emissions are evaluated in such a way. We also analyse removals and avoided emissions that are disclosed by portfolio companies to assess their climate-related opportunities. We use our internal carbon price to calculate the economic value of companies' removals and avoided emissions, and we measure the financial impact on their operating income.

The concerns of companies can be alleviated to a large extent through these exercises, especially as we hold the largest proportion of Japanese equities in the world. We engage with companies, share issues and learn from their feedback around scoring.

Iida, Schroder: What is important about scoring is that it provides a relative position of a company within a sector in relation to its peers. By understanding relative position, our analysts can understand more about if and how a company is building more sustainable relationships with different stakeholders such as the environment, employees, customers, communities, suppliers and regulators. On top of our financial analysis, ESG scoring can be used as an additional tool and we recognize the viability of it. We use a proprietary tool called Context, which is a framework that allows us to analyse a company's relationship with its stakeholders.

We acknowledge that ESG scoring alone does not provide the whole picture. That is why active ownership is such a crucial element of our work. In February last year, we published the engagement blueprint, outlining our ambitions, priorities, approach and expectation for active ownership. We identified six main themes for engagement: climate change, natural capital and biodiversity, human capital management, human rights, diversity and inclusion, and corporate governance. By engaging with companies, we are able to better understand their approach to ESG and drive change that will protect and enhance the value of our investments.

Aihara, Nomura: ESG has an impact on the enterprise value; that understanding is spreading. Some issuers have some complaints about scoring. Their worry is whether the scoring that is published reflects well on what they're doing on the ESG front. If they think it's not reflective well, they have concerns and complaints. We hear those complaints from issuers. We have to communicate about how the scoring is done and what is the methodology and investors too should be proactive in asking questions and having communication with these companies. That is what we try to facilitate and encourage. CDP, Sustainalytics and Bloomberg ESG assessments are being published so issuers are looking at that and investors look at that as they make investment decisions. It's a factor that's taking root to create huge value in the market. So it's only natural for issuers to be concerned about their ESG assessment.

GlobalCapital: What ESG metrics do you look at when assigning ratings to issuers and their debt? What roadblocks do you face?

Masato, DNV: Compared to when ESG finance first appeared in the market, new ESG guidelines and taxonomies have been established, and the axes of ESG evaluation have diversified. In other words, even for the same ESG activity, ESG indicators may have different interpretations and evaluation levels depending on the guidelines.

Of course, it is important to use appropriate guidelines for external evaluation, but it is not acceptable to demand a partially biased viewpoint or an excessive level. This will be an obstacle to the proper development of the market. Currently, taxonomy definitions and ways of thinking about green are gradually spreading, and we believe that the probability of greenwashing will decrease from a qualitative point of view. We believe it is still necessary to create a mechanism to prevent quantitative risk from being monitored by the market and greenwashed. It is also important for market participants to understand that eligible projects may change depending on the situation of each country or region, especially for transition and social financing.

GlobalCapital: What tools can be used to avoid and tackle concerns around greenwashing?

Iida, Schroder: As an example, we use our proprietary tool, SustainEx to aggregate individual companies' externalities and compare a portfolio against the benchmark. This approach is used to address some of the requirements put forward by the EU SFDR. We set a threshold using SustainEx and we disclose the results. By using SustainEx, we are able to compare the outcomes very easily. We also note that we regularly review underlying assumptions of SustainEx and metrics to stay relevant.

Yamaga, Nomura Asset Management: What I'm concerned about is if the ESG impact is different from what you thought it would be, you might call it greenwashing. That is not good. Companies might be not trying to be malicious and trying to hide what they're doing; that's often not their intent. We should refrain from using the term greenwashing too much as it won't encourage positive behaviour. I don't think there are companies that intentionally do this, but perhaps there are a handful of companies that tried to maliciously appear green. There may also be cases where companies would disclose numbers that appear to be inflated compared to reality. We need to compare these with the average of competitors. For example, if the amount of GHG emissions is too large or too small, you might think that something is wrong. If one company in an industry is not making any disclosures about GHG emissions, we can encourage that company to make an improvement and disclose their emissions like peers. If you look at this subjectively, there are areas that you may miss so you need a third-party assessment to bring in a more objective perspective. Transition and ESG bonds have third party opinion that can be used. As professional investors, it's sometimes difficult to cover all the details with respect to ESG. But there are technical experts in think-tanks and government tools that are issued about those entities so we will use that to see whether there's consistency. In all this, engagement is key. If you look at disclosures only, you may miss some information, so having direct dialogue with companies is essential. If greenwashing is suspected, you ask a straight question and see how the company reacts. Such dialogue is very important by meeting them face to face.

Aihara, Nomura: Greenwashing is viewed in two different ways. One is concerning the amount of funds or the proceeds of an issue for which the right projects are not assigned. The other is the lack of effectiveness of ESG initiatives, when they fall below the target. There are certain things to take note of, like the assignment of projects to the proceeds of any issuance must be reported as part of ICMA principles, regulations should be formulated and also all proceeds shall be assigned to the right projects. We have to make sure the issuer does so, whether it is a social bond or green bond, then that line of thinking that I mentioned will be applicable. But sustainability-linked bonds or transition bonds may have a slightly different identification of what is greenwashing.

Kazuyuki Aihara
Nomura Securities

As far as transition bond is concerned, you cannot immediately see the impact as in the form of green bond related exercises. Longer term initiatives would have to be carried out for CO2 reduction for transition so any progress along the roadmap should be reported. Continual disclosure of this kind of approach and progress to the investor will be necessary.

For sustainability linked bonds, there is no labelling as to the use of proceeds but KPIs [key performance indicators] would have to be used for measurement. To what extent these KPIs are important in the light of the ESG initiatives and the importance of a KPI would have to be shown clearly. We should never betray expectations of investors by greenwashing so any disclosure demand should be made. To live up to the expectations from investors, a second party or external reviewer opinion will be extremely important, particularly for transition finance.

Masato, DNV: As a third-party organization, DNV understands the essence of the latest standards and guidelines, and provides evaluations by evaluators who have a background in green-related science and technology and practical experience while collaborating globally. I think we can avoid greenwashing concerns. It is necessary to understand that in ESG finance, it is important to have not only experience and knowledge of finance, but also specific environmental technology and practical experience. It is necessary to build tools that are commonly used and easy to understand by a wide range of market participants through the enhancement of taxonomies and clear policies for countries and industries, for example, formulation of quantified roadmaps and setting of issues or goals. However, I think it is important for users to correctly recognize that taxonomies are not absolute and have limitations, and that they understand the principles and apply them.

DNV recognizes through third-party evaluations that greenwashing is likely to occur in these situations: narrow sense of values when there is an image of competition for greenness within a specific industry; outdated environmental consciousness; lack of knowledge and understanding of technical aspects; and lack of awareness of global trends.

Naturally, it is important to avoid greenwashing by ensuring that each bond meets the rules and principles established through third-party evaluation. Rating agencies participate in roundtables, lectures and seminars like this to share the latest information on greenwashing risks with bond market participants. We believe we can support the sound development of the market.

GlobalCapital: What is the scope for growth of transition bonds in Japan?

Aihara, Nomura: CO2 heavy emitter companies are working on transition financing, and they are looking into this possibility. As Japan is reliant on fossil fuel, the industrial structure would have to be transformed.

Transition finance is something that can support that transformation. That is how I understand it, but then it is not necessarily globally understood. Green bonds and sustainability bonds are easy to understand products that would result in immediate impact and so they are preferred. As far as transition finance is concerned, each industry is rather unique and is not yet well understood by investors. So continued communication with investors would result in the potential expansion of the sustainability financing market.

Yamaga, Nomura Asset Management: Transition bonds can be potentially viewed as an excuse that a not green enough company may use it to help finance GHG emission reduction. Companies may be criticized for making excuses by having transition finance, and this can be partly attributed to the lack of mutual communication or lack of understanding. Achieving net carbon neutrality would require certain initiative that are not understood fundamentally by everyone; we have a long way to go. Mere reduction of GHG emissions wouldn't do. Many already understand that to reduce GHG emissions, time and money are both needed. We tend to focus this discussion on only GHG emission reduction as a transition may have tentative increase in GHG emissions and that may give rise to certain misunderstanding. As as far as transition bonds are concerned, the government, investors and companies would have to work together to facilitate understanding within Japan. If we are not aligned within Japan, if we are not working together as one, then we cannot communicate to parties outside of the country. We need to gain in-depth understanding about the need for transition in Japan. Then we will have to make sure to gain the understanding from the international community.

Here in Japan, we talk about an energy mix that has high dependence on fossil fuels. Meanwhile Japanese companies are actively making commitments and setting their targets including science-based targets (SBT) for achieving their carbon neutral goals. As for SBT, the number of commitments may not be a very large but when it comes to approvals, Japan and the UK are competing for the top among all countries in the world. Japanese companies also have been named the most to the CDP Climate Change A List. Japanese people are very serious and earnest. Disclosures and target setting are taken very seriously by Japanese companies, so transition financing has a lot of potential. But we need to resolve the misunderstanding about Japan and its companies.

Iida, Schroder: The definition of 'transition' is not set in stone. If there's a taxonomy, that could be used as a common language for market participants. But it needs to be suitable to Japan and its unique energy situation and geopolitical factors. The transition pathway for Japan is perhaps different from that of Europe. Nevertheless, transition is a global challenge, so we need discussion at the global level. For Asia's transition finance, I think Japanese financial institutions have a role to play in communicating the priorities for Asia's transition finance to other regions. One way to show the contribution to decarbonization is avoided emissions, but this can be measured in various ways. We need to find a convincing way to explain it to outside of Japan.

GlobalCapital: Will an EU-style taxonomy help or hinder Japan's ESG market?

Aihara, Nomura: As far as EU taxonomy is concerned, even in Japan, issuers issuing foreign currency denominated bonds in euro markets will be requires to align with EU taxonomy by investors. They will be evaluated in EU taxonomy so have to comply with it. The taxonomy is used to judge the green nature of the issue on a quantitative scale and requires that the negative environmental and social effects caused by a project be minimized. But whether or not EU taxonomy is also applicable to transition financing is a question we have been discussing. There are some technical matters relevant to transition. According to the Climate Transition Finance Handbook (CTFH) published by ICMA, transition pathways must be tailored to the sector and operating geographies of an issuer. In order for a taxonomy to be effective for transition, taxonomy must be formulated in a regional roadmap. Market development now will be highly dependent on the transition aspect. Various themes of ESG shall develop, various regions will come into play and there will be development of products from bond to equity. These are things market participants are expecting and willing to work on.

Masato, DNV: The EU taxonomy is extremely useful in understanding what standards and ways of thinking exist in each sector, and has many benefits for the Japanese ESG market. Since the EU taxonomy was created on the premise of European laws and situations, we understand that applying it as it is to the Japanese ESG market, which is different from Europe, would have some adverse effects. But the effective use of the EU taxonomy will reduce the risk of greenwashing.

GlobalCapital: What are your hopes for the ESG market's and the impact investment market's development?

Masato, DNV: We believe the expansion of the ESG/impact investment market is synonymous with progress in solving environmental and social issues. Investors and financial institutions actively create opportunities for ESG and impact investment, and companies promote the development of businesses and technologies that can utilize ESG and impact investment. Solutions to issues will evolve organically.

Iida, Schroder: I hope that companies and issuers would get more deeply involved in rulemaking. That is the wish of investors – that they will be deeply involved in the early stages to develop disclosure in ESG investment. That will be the way to have Japanese companies positioned well for global rulemaking. I would also like to note that 'S' of ESG is a fast-moving space. Since the Covid-19 pandemic, Japanese companies have evolved, they are trying to accommodate various ways of working nowadays, and finding ways to secure excellent talent and retain them to have a competitive edge and boost productivity. Also, the regulatory environment for human rights has been fast evolving in Europe, the US as well as in Japan to a certain extent. We need to understand that ESG is not a monolithic concept. GC

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