

# 8

## Sustainable finance definitions in Japan

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This chapter provides background on the guidelines for green bonds, green loans and sustainability linked loans. These definitions are principle-based and contain guidance on metrics.

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## 8.1. History and present status of sustainable finance definitions in Japan

### 8.1.1. Introduction

In the case of Japan, no legislative definition falls into the strict category of a “taxonomy”. Japan has not issued a sovereign green bond. The sustainable finance guidelines issued so far by the Japanese authorities are principle-based, they contain metrics guidance but no thresholds.

Japan, the world’s third largest economy, is home to some of the most powerful financial institutions in the world. It also boasts one of the main global financial centres, Tokyo. As host country, Japan was instrumental in concluding international negotiations in 1997 on the Kyoto Protocol under the UN Framework Convention on Climate Change (UNFCCC). The Bank of Japan is a member of the Central Banks Network for Greening the Financial System (NGFS). Emerging sustainable finance practices in Japan include increasing consideration of environmental, social, and governance (ESG) criteria in financial decision-making and the development of green bond and sustainable investment markets (Schumacher, Chenet and Volz, 2020<sup>[1]</sup>). Between 2016 and 2018, Japanese investment in sustainable assets increased 307 percent, outpacing other countries and Europe. One publicly owned institution that has played a crucial role in promoting ESG in Japan is the Government Pension Investment Fund (GPIF), the world’s largest pension fund, which was created in 2006, managing over JPY 159 trillion (Japanese yen) as of 31 March 2019. In 2017, the GPIF adopted an ESG investment strategy and selected ESG indices. In December 2018, the GPIF expressed its support for the Task Force for Climate-related Financial Disclosures (TCFD) recommendations.

In addition, many Japanese financial actors are seeing benefits in increased climate risk assessment and transparency. At the end of 2018, The Ministry of Economy, Trade and Industry (METI) declared its support for the TCFD Recommendations and released its TCFD Guidance to show companies the first steps that they should take in starting information disclosures in accordance with the TCFD Recommendations (METI, 2018<sup>[2]</sup>). As of December 2019, the number of organisations supporting the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) stood at 930 worldwide (FSB, 2019<sup>[3]</sup>). As of 6 March 2020, 240 organisations from Japan had joined the Japan TCFD Consortium (TCFD, 2020<sup>[4]</sup>), making it the world’s largest such consortium.

### 8.1.2. The sustainable investment market

Despite significant market growth rates in recent years, the size of Japan’s sustainable finance markets is still relatively low in comparison to other countries. As of 19 April 2020, 84 Japanese organisations had signed up to the Principles for Responsible Investment (PRI). This compares to 2954 PRI signatories in the rest of the world. Japan’s sustainable investment under management was JPY 263 trillion (USD 2.4 billion) at the beginning of 2018, compared with USD 14.1 trillion in Europe and USD 12.0 trillion in the U.S. (GSIA, 2018<sup>[5]</sup>).

### 8.1.3. The green bond market

Japan’s green bond market is the ninth largest globally and the second largest in the Asia-Pacific region after China with its cumulative issuance amounting to ¥1,875bn (US\$17bn) as of end-2019. Green bond issuance for 2019 recorded a 70% increase compared to 2018, totalling ¥786.7bn. Financial corporates dominate the market, accounting for 50% of issuance (¥938.8bn). The Japanese market has a high proportion of external reviews with about 90% of its issuance with 60% of deals by volume benefiting from a Second Party Opinion (SPO) and 21% with at least a green bond rating (CBI, 2019<sup>[6]</sup>).

As for use of proceeds, buildings dominate cumulative proceed allocations at 38%. Significant contributions in this sector came from the Development Bank of Japan (cumulative ¥188.3bn), while Japan Housing

Finance Agency (¥70bn) represented the largest green buildings issuer in 2019. Energy (29%) and transport (25%) follow, with financial corporate Mitsubishi UFG Financial Group (¥216.3bn) and government-backed entity JRJT (¥197bn) representing the top issuers in the respective sectors. The Tokyo Metropolitan Government is the first Japanese issuer to allocate proceeds to adaptation and resilience, with cumulative ¥13.5bn earmarked towards flood prevention mechanisms. Japanese issuers prefer shorter tenors with 57% of bonds having a tenor of up to five years while 27% falling in the ‘five-to-ten years’ category. Ten percent of volumes have a tenor of more than 20 years. Issuance from the Development Bank of Japan and around 50% of non-financial corporates volumes have tenors of up to five years. The same tenor bucket is also the most popular amongst financial corporates, with almost 60% (¥178.7bn) of proceeds from Mitsubishi UFG maturing within five years. In terms of international comparability, most green bonds issued to date (above 80%) have received a second opinion and are consistent with the Climate Bonds Initiative Taxonomy. Currently external reviewer Sustainalytics (now owned by Morningstar) has a major share of the Japanese Green bond market, with other players such as DNV GNL, Vigeo Eiris (now owned by Moody’s) or ISS Oekom (now owned by S&P) present as well.

Japan has various certification schemes for energy efficiency and performance in buildings that allow for the identification of low carbon buildings. The Japan House Finance Agency entered the green bond market in early 2019, through the securitisation of residential mortgages under the “Flat 35S” efficiency scheme. This is the same kind of structure as that used in the U.S. by the Federal National Mortgage Association (“Fannie Mae”) to issue green bonds. Fannie Mae Green Bonds are green mortgage-backed securities (MBS) created through the aggregation and securitisation of green mortgages (home loans). Eligibility requirements for loans include reduction of the property’s annual energy usage by at least 15%, and combined energy and or water savings of at least 30% (Fannie Mae, 2019<sup>[71]</sup>).

#### **8.1.4. Sustainable finance definitions**

In 2017, the Ministry of the Environment of Japan (MOEJ) launched Japan’s green bond guidelines. The aim was to promote the further spread of domestic green bonds while ensuring the reliability of the environmental effects of green bonds and reducing the costs and administrative burdens for issuers, as well as consistency with the International Capital Markets Association (ICMA) Green Bond Principles. The 2017 guidelines were principle-based and do not contain strict eligibility criteria or thresholds. The green bond guidelines were revised in 2020 to account for the revision of the ICMA Green Bond Principles, and to include more products. They are presented in more detail below (MOEJ, 2020<sup>[6]</sup>). For its part, the Ministry of Economy, Trade and Industry of Japan (METI) also issued a good practice guide for climate adaptation by the Japanese private sector, which consists of 20 one-sheet summaries of model corporate adaptation policies.

## **8.2. Objectives and scope of the 2020 green bond, green loan and sustainability linked loan guidelines**

In its 2020 revision of the green bond guidelines – renamed the 2020 Green Bond, and Green Loan and Sustainability Linked Loan guidelines (henceforth JGB&GLSLL) -- the MOEJ was attentive to the provision of funds for green projects not only by bonds but also by loans. It also introduced sustainability-linked loans, which are loans where financing conditions, such as the level of interest rate, are reviewed in line with the progress of the borrower on pre-determined Sustainability Performance Targets (SPTs). Experimentation with loans involving variable financing conditions was undertaken in Japan as far back as in 2004, when the Development Bank of Japan provided the first environmentally rated loan, ahead of other countries. The JGB&GLSLL aim at encouraging corporate behaviour, via finance, to become environmentally friendly, and developing green finance markets via voluntary adoption. In particular, they recognize that “green bonds are becoming an effective tool to raise funds for green projects, such as those

contributing to the reduction of greenhouse gas (GHG) emissions and the prevention of natural capital deterioration. This trend became noticeable after the establishment of the Green Bond Principles (GBP) with the support of the International Capital Market Association (ICMA) in January 2014. Green Bond issuances and investments started to be seen in Japan as well. The spread of Green Bonds in Japan, however, is slow in comparison with other countries. (MOEJ, 2020, p. 15<sup>[8]</sup>). The general aim of the guidelines can be summarized as securing the credibility of green characteristics of the use of proceeds (i.e. seeking to avoid green washing), while alleviating the costs and administrative burdens for issuers. They also seek to spur knowledge accumulation in the market, by encouraging investors to disclose, and having the market evaluate the information disclosed by the issuer.

The 2020 JGBG&GLSLL are consistent with the ICMA Green Bond Principles and consistent with the Green Loan Principles and Sustainability Linked Loan Principles formulated in 2018 and 2019 respectively by the Loan Market Association (LMA). The guidelines also refer to other international classifications, including the EU Taxonomy, as potential additional, complementary tools: “It should be noted that international efforts are being made to classify environmentally sustainable economic activities in order to specify the eligible recipients of investments and loans in sustainable finance. This classification could function as an additional reference document regarding issuers who, for instance, wish to issue bonds in a bond market in the region that takes part in such efforts and will help investors identify eligible green projects” (MOEJ, 2020, p. 14<sup>[8]</sup>). The next sections set out the guidelines for each product (green bonds, green loans, and sustainability linked loans).

### **8.2.1. Objectives and scope of the 2020 green bond guidelines (JGBG)**

The JGBG define green bonds as “bonds issued by companies, local governments, or other organizations to raise funds for domestic and overseas green projects” (MOEJ, 2020, p. 16<sup>[8]</sup>). The projects financed should not have “serious negative social impacts” (MOEJ, 2020, p. 17<sup>[8]</sup>). “Sustainability bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or refinancing a combination of green and social projects, and which align with the four core components of the Green Bond Principles and/or Social Bond Principles (SBP)”. The guidelines for green bonds also apply to sustainability bonds. The guidelines state that green bonds are expected to incorporate and reflect four components:

- Use of proceeds
- Process for project evaluation and selection
- Management of proceeds
- Reporting and (5) External review

#### *Use of proceeds*

- The green bonds proceeds should be allocated to green projects that have clear environmental benefits, with a recommendation to quantify them if possible, and some indications to that effect, as detailed below.
- Use of proceeds may include research and development expenses, human resources education expenses and monitoring expenses in connection with such projects.

The guidelines provide an indicative, non-exhaustive sector list summarised below:

- Renewable energy (including generation, transmission, appliances, and products)
- Energy efficiency (such as new and refurbished energy efficient buildings, energy storage, district heating, smart grids, appliances and products)

- Pollution prevention and control (including waste water treatment, GHG control, soil remediation, “3R-based” (reduce, reuse, recycle) waste management and waste-to-energy, and associated environmental monitoring analysis)
- Sustainable management of living natural resources and land use (including environmentally sustainable agriculture, fishery, aquaculture, and forestry, integrated pest management, weed management, and drip-irrigation)
- Projects for terrestrial and aquatic biodiversity conservation (including the protection of coastal, marine, and watershed environments)
- Projects for clean transportation (such as energy efficient next-generation vehicles, public transportation, railways, bicycles, non-motorized, multi-modal transportation, infrastructure for clean energy vehicles and the reduction of harmful emissions)
- Projects for sustainable water management (including sustainable infrastructure for clean and/or drinking water, sustainable urban drainage systems, and river draining and other forms of flood mitigation)
- Projects for climate change adaptation (including information support systems, such as climate observation and early warning systems)
- Projects concerning eco-efficient products, production technologies, and processes (including the development and introduction of environmentally friendlier, eco labelled, or certified products, and packaging using recyclable or renewable resources or other materials which reduce environmental loading)
- Projects to newly build or renovate green buildings that not only are energy efficient but also address a wide range of issues for consideration such as water consumption or waste management. Compliance with domestic standards or with an environmental certification that demonstrates a high level of efficiency in the environmental certification system, such as LEED<sup>1</sup> and CASBEE<sup>2</sup>, is sought.

The guidelines recognise that some green projects may have incidental negative impacts on the environment, in addition to their intended environmental benefits. In such cases, the guidelines prescribe that those negative environmental impacts are evaluated by the issuers as limited compared to their environmental benefits, and that the issuers should include information regarding these negative impacts (e.g., how they are assessed, what the issuers will do to curb them) to investors so that the investors and market participants can appropriately evaluate these impacts. The guidelines propose examples of such negative impacts for each broad category of eligible projects. Examples provided for a solar power generation project include (MOEJ, 2020, p. 75<sup>[8]</sup>) :

- Ecological disruption or adverse effects on ecosystems caused by massive land development
- Outflow of muddy water
- Spilling of soil such as topsoil
- Light pollution and adverse effect on scenery
- Noise and vibration from the relevant facilities.

### **8.2.2. Process for project evaluation and selection**

Issuers should inform investors of the environmental sustainability objectives they intend to achieve with the green bonds and the criteria for selecting the projects accordingly. Examples of environmental objectives are climate change mitigation, adaptation, and the conservation of biodiversity. For climate change mitigation, the criterion can be GHG emissions reductions.

*Management of proceeds*

The issuer should conduct periodic checks (at least yearly) to ensure that the amount allocated to green projects is equal to or greater than the amount raised by the issuance of green bonds.

*Reporting*

Issuers should disclose how the funds are used at least once a year until all the proceeds are used and whenever there has been a major change in the situation. More specifically, disclosure methods may include disclosing environmental benefits per project, such as the amount of carbon dioxide reduced per year.

*External review*

It is recommended that issuers provide an external review. External reviewers should follow professional ethical standards, including integrity, fairness, ability and due care.

**8.2.3. Objectives and scope of the 2020 green loan guidelines (GL)**

The Green Loan Principles (hereinafter referred to as “GLP”) were published in March 2018 by the Loan Market Association (LMA) and the Asia Pacific Loan Market Association (APLMA)<sup>3</sup>. The Japan Green Loan Guidelines state that “proceeds should be allowed exclusively to green projects, tracked and managed in a reliable manner, and transparency should be ensured by reporting after the issuance of the bonds” (MOEJ, 2020, p. 45<sup>[8]</sup>). The guidelines signal that this framework could become an effective tool to attract private funding to businesses that contribute to the reduction of GHG emissions and prevention of natural capital deterioration in Japan. The guidelines state that a green loan is expected to incorporate and reflect four components:

- Use of proceeds
- Process for project evaluation and selection
- Management of proceeds
- Reporting

The criteria are very similar to those for green bonds above.

**8.2.4. Objectives and scope of the 2020 sustainability linked loans guidelines (SLL)**

The guidelines also refer to the sustainability linked loan principles (referred to below as “SLLP”) formulated in March 2019 by the Loan Markets Association (LMA), the Loan Syndications and Trading Association (LSTA) and the Asia Pacific Loan Markets Association (APLMA), in order to promote sustainable economic activities. A sustainability-linked loan (SLL) is a loan that encourages borrowers to achieve ambitious sustainability performance targets (SPTs). Specifically, it is a loan that: (1) organises the relationships between sustainability objectives and SPTs set out in the borrowers' comprehensive social responsibility strategies; (2) measures the degree of improvement in sustainability by setting appropriate SPTs; and (3) ensures transparency through post-loan reporting on SPTs. Unlike green loans, SLLs are often used for general business purposes, not limited to specific projects. The SLLP provide a framework that ties improvement of sustainability performance of borrower companies, to loan terms (such as interest). The guidelines mention that SLLs can be a tool for promoting governance, strategies and risk management systems for sustainability within businesses and throughout their supply chains, as well as for meeting voluntary ESG information disclosure requirements recommended by the Task Force on Climate-related Financial Disclosures (TCFD) and others. SLLs are expected to contain four components:

- Reconciling the relationship between the borrower's sustainability goals and sustainable performance target (SPTs)
- Setting of appropriate SPTs and measurement of sustainability
- Reporting
- External review

#### *Borrowers' sustainability goals*

The Borrower of an SLL should inform the lender that the sustainability objectives set out in its comprehensive social responsibility strategies are consistent with the SPTs.

#### *SPT measurement*

Borrowers are invited to select one or more Sustainability Coordinator(s) or Sustainability Structuring Agent(s) to help them negotiate SPTs setting. The SPTs includes key performance metrics (KPIs), external ratings, and comparable metrics to measure the borrowers' improvement in sustainability. The SPTs should be ambitious and refer to a business line of activity, which is material to the borrower. They should also be quantitative and based on recent data (less than one year). Typically, lending conditions are tied to performance achievement, with the interest rate lowered if the SPTs are met, or raised if the targets are not met.

#### *Reporting*

Reporting should be at least yearly. Where feasible, ESG ratings by external agencies related to the achievement of SPTs can be provided.

#### *External review*

The need for External Review is determined by agreement between Borrowers and lenders.

## **8.3. Metrics and thresholds**

### **8.3.1. Metrics for measuring environmental effects**

The guidelines provide numerous examples of indicative metrics and methodologies for measuring and disclosing the environmental effects of green projects. But they don't provide eligibility thresholds within categories. Examples of indicative metrics provided are shown below:

#### *Renewable energy*

- Reduction in CO<sub>2</sub> emissions (tCO<sub>2</sub>)
- Electricity generated by renewable energy (GWh)
- Renewable energy utilization rate in manufacturing process (percentage)

#### *Energy conservation*

- Reduction in CO<sub>2</sub> emissions (tCO<sub>2</sub>)
- Reduction in energy consumption (k/L, t, m<sup>3</sup>, MWh)

## 8.4. Outlook and next steps

In March 2020, the METI's Study Group on Environmental Innovation Finance published a concept paper (METI, 2020<sup>[9]</sup>) on Climate Transition Finance Principles. Those principles call for further climate action aligned with the Paris Agreement. The tendency in sustainable finance in Japan has been to increasingly emphasize transparency and impact and an increase in the issue of transition bonds could ensue as a logical consequence, particularly in the context of the financing needs of the recovery from Covid-19.

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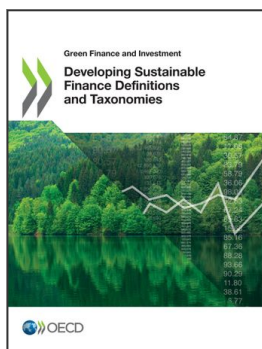


## Notes

<sup>1</sup> LEED stands for Leadership in Energy and Environmental Design. It is a certification programme for Green Buildings developed by the U.S. Green Building Council that started in the U.S. It assesses the energy efficiency and other comprehensive environmental load of buildings. There are four certification levels—standard, silver, gold, and platinum.

<sup>2</sup> CASBEE stands for the Comprehensive Assessment System for Built Environment Efficiency, which is the green building management system in Japan. This system was developed by a research committee established in 2001 through the collaboration of academia, industry and national and local governments, which established the Japan Sustainable Building Consortium (JSBC) under the auspice of the Ministry of Land, Infrastructure, Transport and Tourism (MLIT). Various CASBEE schemes are now deployed all over Japan and supported by national and local governments. Under the system, buildings are evaluated and rated according to their environmental performance based on their building quality comprehensively, evaluating not only the use of energy efficient and environmentally-friendly materials, but also interior comfort and harmony with the surroundings. The evaluation results are rated on a scale of one to five levels ranging from S rank (excellent) to C rank (inferior) (IBEC, 2020<sup>[11]</sup>).

<sup>3</sup> The LMA is the trade body for the Europe, Middle East and African syndicated loan market and was founded in December 1996 by banks operating in that market. It develops standards of documentation and codes of market practice. The APLMA and LSTA are equivalent organisations in Asia and the USA respectively.



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