



Index insights | Sustainable investment | Equity

Rewarding ESG disclosures

Improvements and challenges in ESG scores of Japanese companies (part 2)

December 2024

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Written in collaboration with SGX

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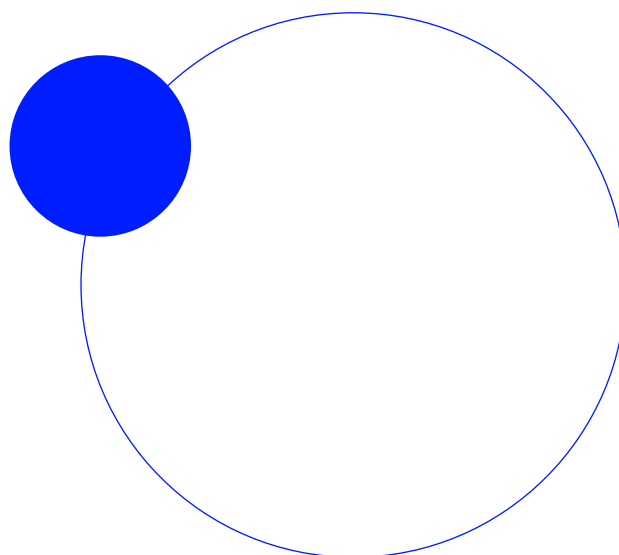


Quarterly analysis

Authored in collaboration with SGX, this report reviews the development of Japan's sustainability standards, the environmental, social and governance (ESG) performance of listed companies in Japan compared to market-specific indices, and the growth of index-linked SGX FTSE Blossom Japan Index Futures.

Key highlights from this quarter's analysis:

- The gap between the ESG performance of Japan and European companies (as measured by the FTSE Russell ESG score) has narrowed, and the environmental score is approaching parity
- However, the disclosure rate of Japan companies in the social and governance domains continues to lag behind Europe
- Both Blossom Japan and Blossom Sector Relative Indices reported quarterly underperformance relative to their benchmark FTSE Japan All Cap Index, largely caused by the negative contribution from the ESG factor
- The SGX FTSE Blossom Japan Index Futures continues to remain the global leader amongst Japan ESG derivatives, with market share of 99% (in terms of Open Interest in USD notional)



Japan's public pension signed PRI

At last year's PRI in Person event in Tokyo, then Prime Minister, Fumio Kishida, mentioned that at least seven Japanese public pension funds would sign the Principles for Responsible Investment (PRI). According to the PRI documents as of August 2024 this year, there had been 140 signatories (mostly asset managers) in Japan.

PRI encourages responsible investments, the integration of ESG into investments and stewardship activities. Regarding ESG integration, the method taken may vary depending on the signatory organisation, but it is expected that new investments and increasing assets into ESG indices will occur in the future. There is also a possibility that this trend will gradually spread to not only public pensions but also corporate pensions.

ESG scores of Japanese companies continue to improve

The FTSE Russell ESG scores of companies are often used as criteria for inclusion in FTSE Russell ESG related indices. Our previous research paper "[Rewarding ESG disclosures](#)", published in June 2024, uses FTSE Russell ESG Scores to analyse Japanese companies, and finds:

- The gap in ESG performance between Japanese companies and their European counterparts (as measured by FTSE Russell ESG Scores) is closing, with their environmental scores now nearing parity
- However, challenges remain for Japanese companies, particularly in the Social and Governance domain, where disclosure rates still lag those seen in Europe

Figure 1. FTSE Russell ESG Scores – December 2023/December 2020



Source: FTSE Russell ESG Scores, December 2023. The score data is weighted by market capitalisation.

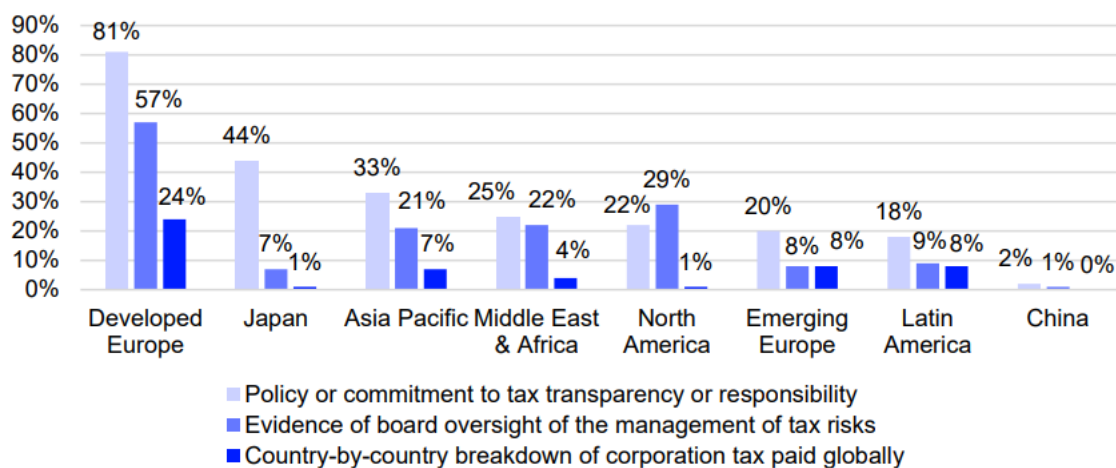
Also in our previous research paper, the reason for the inferior social score was that ‘social’ has a wider range of themes compared to environment, and the themes that are considered important (or material) for companies vary greatly depending on the industry and corporate activities. We highlighted that this may be due to the difficulty in standardising corporate disclosures rather than taking into account social impact.

Trends and issues in governance disclosure in Japanese companies

Following on from the previous section on social scores, let's take a closer look at the trend of governance in the ESG pillar.

Figure 2 shows that Japanese companies had lower average governance scores than European counterparts across all four themes as of June 2021. For example, Japanese companies disclosed policies or commitments to tax transparency or responsibility, but this was significantly below developed European countries and below other regions in terms of evidence of board oversight of the management of tax risks and country-by-country breakdown of corporation tax paid globally.

Figure 2. Proportion of companies reporting on key tax issues by region – June 2021



Source: FTSE Russell, June 2021.

In addition, one of the frequently asked questions about corporate governance is the definition of ‘independent director’ and ‘non-executive director’. A non-executive director is a director who is not an employee of the company and does not engage in daily management of the company. A non-executive director may also be referred to as an ‘outside director’, and under the Japanese Companies Act, is a director who is not employed by the company, its subsidiaries or its parent company.

In this regard, the companies did not fully meet the indicators of the ‘Audit Committee’ and the ‘Remuneration Committee’ in the FTSE Russell ESG Scores methodology, if there is no committee composed only of non-executive directors (in many cases, the committee includes executive directors).

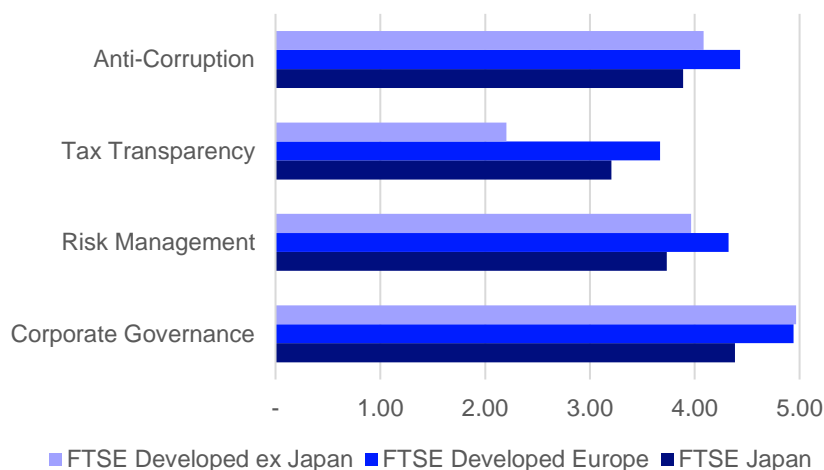
This may be due to cultural or regulatory differences in corporate governance in Japan and globally. The FTSE Russell ESG Score evaluates if the members of Audit Committee and the Remuneration Committee are fully non-executive members in the committee as a first criteria. Then, the number of independent directors determines the score.

Japan's governance scores have improved significantly over the past three years

As of June 2021, there was a significant difference in governance scores. However, looking at Figure 3, by December 2023, while the average governance score of Japanese companies is still lower than the score of developed countries in Europe, it

is much closer to the average global score. It is much closer to developed countries ex-Japan and much higher in tax transparency.

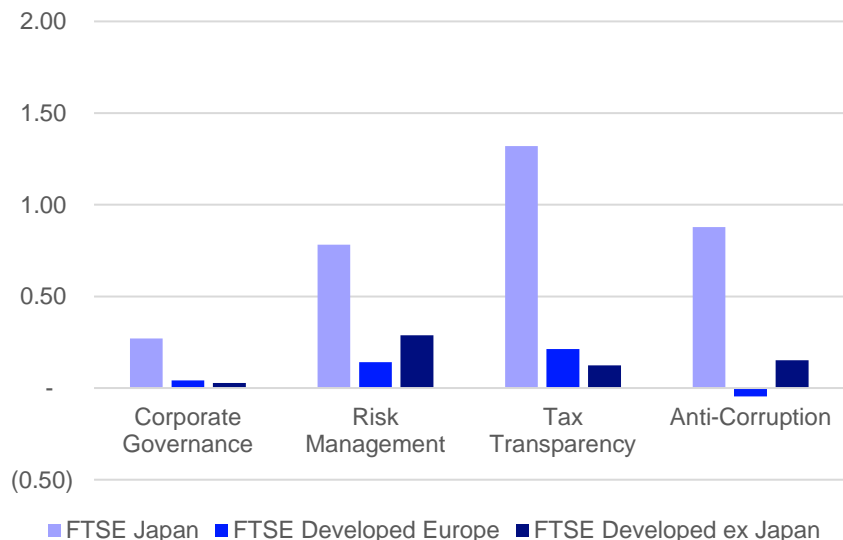
Figure 3. FTSE Russell Governance theme Scores – December 2023



Source: FTSE Russell ESG Scores, December 2023. The score data is weighted by market capitalisation.

We also find Japan’s governance scores have improved significantly over the past three years compared to other countries.

Figure 4. Improvement of governance scores by countries – December 2023 vs. December 2020



Source: FTSE Russell ESG Scores, December 2023. The score data is weighted by market capitalisation.

What could the contributing factors influencing this in the disclosures of Japanese companies be? We believe one reason for this could be the recent regulatory encouragement of disclosures and the growing awareness of ESG reporting to attract investment. For example, in the case of the Blossom Japan Index, ongoing corporate

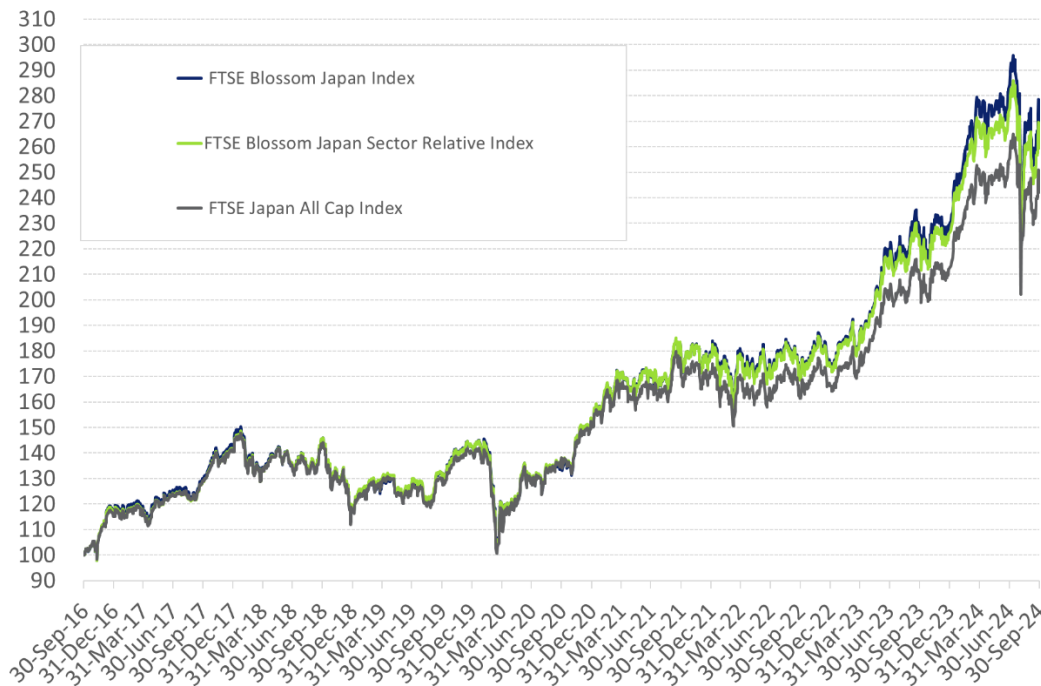
engagement with FTSE Russell has contributed to a better understanding of the FTSE Russell ESG score criteria.

Governance disclosure becomes increasingly important

In terms of governance, Japanese companies are getting closer to Europe and the United States, but there may still be a unique culture of corporate governance in Japan. Compared to the average FTSE Russell ESG Governance theme Score of developed countries, three themes of corporate governance, risk management and anti-corruption are below developed country counterparts. Disclosure of information on these three themes could be improved.

Long-term performance remains strong, despite quarterly underperformance vs. benchmark

Figure 5. Blossom Index Series maintains long-term outperformance vs. benchmark



Source: FTSE Russell. Data as of 30 September 2024.

For the first time since September 2023, when we adopted the ESG factor model for the attribution analysis of Blossom Japan series ([Why Japan? Why sustainable investments? Why now? | LSEG](#)), both Blossom Japan and Blossom Japan Sector Relative Indices reported a negative contribution from the ESG factor this quarter. The Blossom Japan Index underperformed the benchmark FTSE Japan All Cap Index by 184bp (ESG factor contribution -243bp), and FTSE Japan Blossom Sector Relative Index by 108bp (ESG factor contribution -128bp).

Figure 6. Attribution analysis for FTSE Blossom Japan Index (bps)

| Period | Industry | Value | Quality | Volatility | Momentum | ESG | Residual | Total excess |
|-------------------------|----------|-------|---------|------------|----------|-------|----------|--------------|
| 2015/12/31 - 2024/06/28 | -250 | 210 | -157 | -221 | 319 | 1,875 | 266 | 2,042 |
| 2015/12/31 - 2024/09/30 | -225 | 199 | -187 | -203 | 266 | 1,632 | 377 | 1,858 |
| Quarterly change | 25 | -11 | -30 | 18 | -53 | -243 | 111 | -184 |

Source: FTSE Russell, Data as of 30 September 2024. Data covers the period from 31 December 2015 to 30 September 2024.

Figure 7. Attribution analysis for FTSE Blossom Sector Relative Index (bps)

| Period | Industry | Value | Quality | Volatility | Momentum | ESG | Residual | Total excess |
|-------------------------|----------|-------|---------|------------|----------|-------|----------|--------------|
| 2015/12/31 - 2024/06/28 | -45 | 44 | -174 | -75 | 335 | 1,043 | -11 | 1,118 |
| 2015/12/31 - 2024/09/30 | -28 | 44 | -170 | -69 | 307 | 915 | 12 | 1,011 |
| Quarterly change | 16 | 0 | 3 | 5 | -28 | -128 | 23 | -108 |

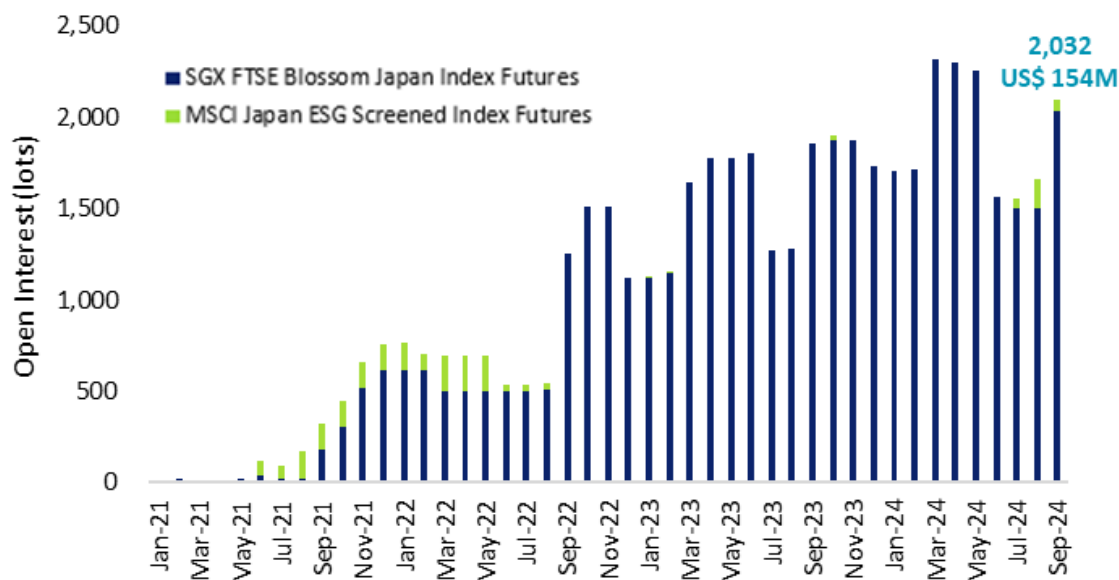
Source: FTSE Russell, Data as of 30 September 2024. Data covers the period from 31 December 2015 to 30 September 2024.

The significant turmoil observed in the Japanese equity market in August 2024 seems to have created a risk-averse atmosphere associated with profit-taking market reactions. Nevertheless, both Blossom Japan and Blossom Sector Relative Indices maintain significant outperformance over their benchmark on a long-term cumulative performance basis, due in large part to the ESG factor (+1,632bp (ESG)/+1,858bp (total) and +915bp (ESG)/+1,011bp (total), respectively). These long-term performance results may continue to imply the statistical evidence of the existence of the ESG factor in the Japanese equity market.

SGX FTSE Blossom Japan Index Futures contract remains the global leader amongst Japan ESG derivatives

The SGX FTSE Blossom Japan futures contract remains the global leader amongst Japan ESG derivatives, with market share of 99% (in terms of Open Interest (OI) in USD notional).

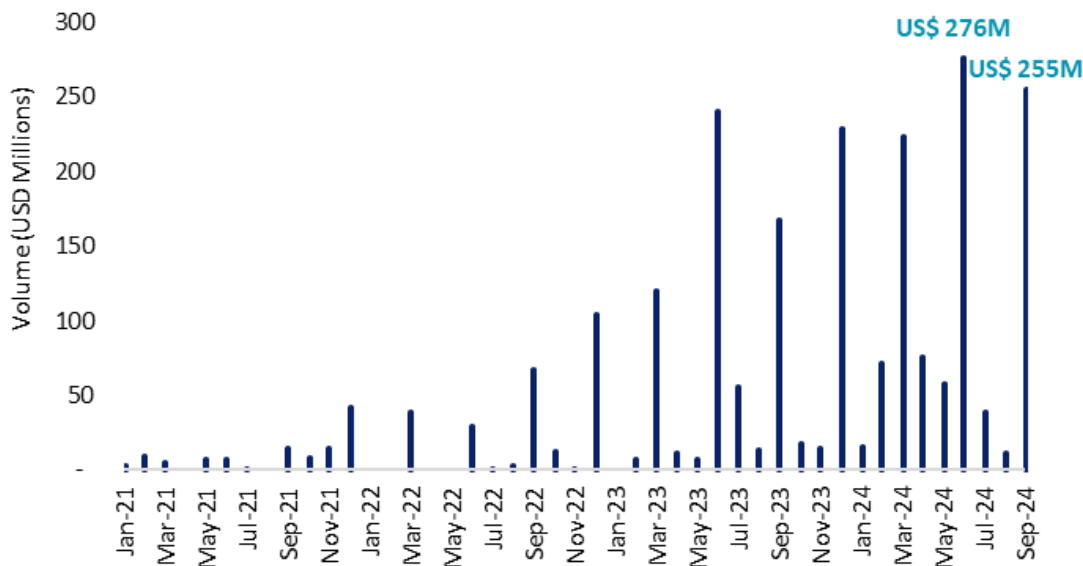
Figure 8. Meaningful OI on SGX FTSE Blossom Japan vs. other Japan ESG Futures



Source: SGX. Data from January 2021 to September 2024. Past performance is no guarantee of future results. Please see end for important legal disclosures.

At the time of writing, the volume trend indicates a rise during the Japanese dividend season, suggesting the futures contract is gaining popularity as a tool for cash equitisation.

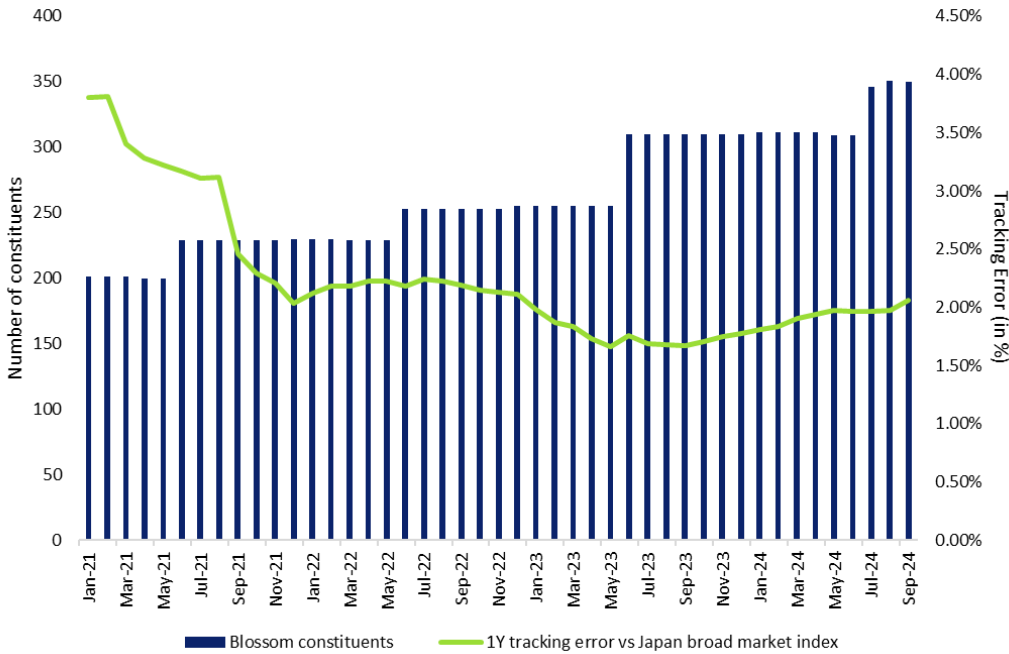
Figure 9. Rising volumes of SGX FTSE Blossom Japan contract with increased adoption



Source: SGX. Data from January 2021 to September 2024. Past performance is no guarantee of future results. Please see end for important legal disclosures.

Over time, the number of constituents of FTSE Blossom Japan has expanded, indicating Japanese companies are making efforts to disclose ESG metrics and corporate governance metrics. As can be observed in Figure 10, a growing basket has led to lower tracking error of the FTSE Blossom Japan index compared to the Japan broad-market index. The basket is hyper liquid for those looking at entering positions via blocks.

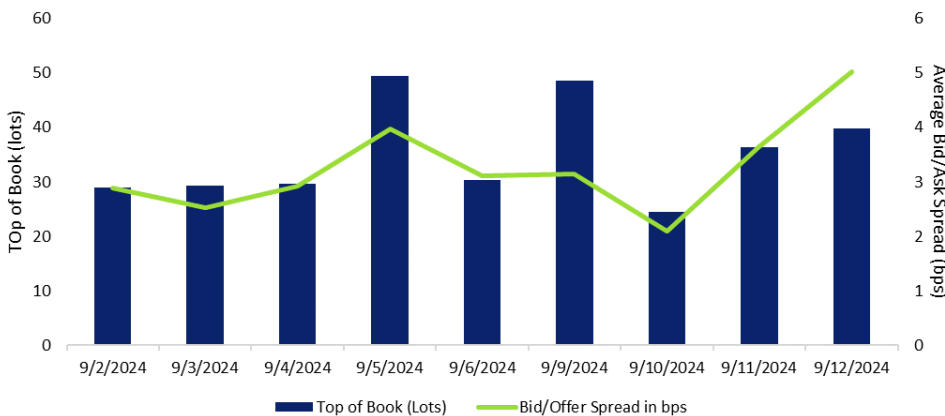
Figure 10. Growing size of FTSE Blossom Japan index basket (LHS), driving tracking error (RHS) lower



Source: SGX. Data from January 2021 to September 2024. Past performance is no guarantee of future results. Please see end for important legal disclosures.

Roll activity remained robust in September, with an average top of book size and spread of 35 lots and ~3.4bps, respectively, despite the market volatility; ~95% of the September positions were rolled out to December maturity over LTD-10-day window. Post roll, ~80% of positions are held on December 2024 and ~20% on March 2025 expiries.

Figure 11. Calendar roll average top of book (LHS) and bid/offer (bps)



Source: SGX. Data from January 2021 to September 2024. Past performance is no guarantee of future results. Please see end for important legal disclosures.

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