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ABSTRACT

In this paper we review the growth of socially responsible investment (SRI) in the UK and in Japan. We consider the various factors which have given rise to the growth of SRI in both countries. As SRI is currently more mature in the UK than in Japan, we consider ways in which the UK experience may provide some lessons for the growth of SRI in Japan. Significantly, we consider that the use of corporate governance mechanisms such as engagement and dialogue by large shareholders, to solve social, ethical and environmental (SEE) problems in companies is a realistic route for the development of SRI in Japan. However, these mechanisms need to be designed so that they may operate more efficiently. Pension funds and other investment institutions need to appreciate the value of engagement over screening as an SRI strategy. Further, the disclosure of SRI strategies by pension funds in Japan may contribute to enhancing consciousness about the responsibility of shareholders for the SEE outcomes of corporate activities that they invest in indirectly. We acknowledge however, that this suggestion may be difficult to implement in the near future

Introduction

In the UK, recent years have witnessed socially responsible investment (SRI) move from the margin to mainstream institutional investment (Mansley, 2000). A similar growth has occurred in Japan, but at a different level: SRI in Japan has grown from being non-existent to being a recognised marginal form of institutional (and individual) investment. In this paper we review the growth of SRI in the UK and Japan. We compare and contrast the growth of SRI in these two major economies. We then consider ways in which the experience in the UK could help pave the way for future growth of SRI in Japan.

The Growth of Socially Responsible Investment in the UK

A recent study concludes that the UK SRI sector is becoming more powerful and influential, with the City taking an increasing interest in the area (Friedman and Miles, 2001). FT article. This transformation seems to have been motivated by a number of factors, with evidence suggesting that the main driver has been the activities of social/environmental lobby groups and interest in SRI from the UK Government, as well as the desires of individual scheme members (Solomon, Solomon and Norton, 2002). Recent corporate cases of social, ethical or environmental (SEE) misconduct and mismanagement have also turned the spotlight on SEE issues. The need for companies to become more accountable to a broader range of stakeholders by managing SEE issues more carefully and increasing SEE disclosure has been a focus of lobbyists, Government and investors for a number of years (Peattie, Solomon, Solomon and Hunt, 2002). Unless companies embrace corporate social responsibility (CSR) and improve their accountability and transparency they are unlikely to remain competitive in the future, as the risks of unethical behaviour to their reputation have been recognised as significant (Wheeler and Sillanpää, 1997). Further, if institutional investors, who represent the controlling shareholder group in the UK, endorse SRI, this will be a significant factor influencing the attitudes of company management towards SEE issues. There has been a dawning realisation in recent years that the immense power of collectivised investment can be used or abused, and that pooled funds may be wielded as a force for good.

The demand for SRI which has arisen from the institutional investor clientele (especially from pension fund members) demonstrates an increasing societal awareness of SEE issues and requiring fund managers to consider the SEE implications of their investment choices. Recent market research indicated that 77% of the UK public would like their pension funds to be invested in a socially responsible way provided this did not reduce financial returns (Targett, 2000). Another study indicated that almost 80% of pension scheme members required their schemes to operate an SRI policy (The Ethical Investor, 1999). Interest from the institutional investment community has been perceived as relatively weak with fund managers adopting an SRI strategy in reaction to external pressure rather than on their own initiative. However in the last couple of years their attitudes have changed dramatically. Institutional investors have started to view SRI as an increasingly important issue in portfolio investment (Friedman and Miles, 2001). Rather than viewing SRI as an issue to be isolated to individual, specialist 'ethical' funds, social, ethical and environmental SRI has been adopted as an umbrella policy across almost all major funds. Indeed, SEE issues constitute one of the main categories discussed in engagement and dialogue meetings between institutional fund managers and their investee companies (Jubb, 2002; Solomon and Solomon, 2003).

Why Has Socially Responsible Investment Grown in the UK?

The quintessential issue for the institutional investment community, when deciding whether or not to adopt and SRI approach is whether or not there is a positive relationship between SRI and financial performance. However strongly investors desire to invest in a socially responsible manner, the prospect of lower financial returns on socially responsible funds would act as a strong disincentive for SRI. Indeed, as SRI is rising it is likely that investors believe they will make equal, if not higher, returns from socially responsible than from non-SRI and it seems that investors and fund managers believe it is possible to make a difference while making a profit (Drexhage, 1998). There appears to be a growing perception within the UK institutional investment community that SRI actually enhances investment return (Mayo, 2002). Indeed, the majority of institutional investors now operate an SRI overlay strategy which incorporates engagement with investee companies on SEE issues as part of the integrated investment process (Solomon and Solomon, 2003). However, institutional investors are hungry for concrete evidence and, although they are actively pursuing SRI strategies at present, still require as much information on links with performance as possible. We now consider SRI in the UK from a number of angles, each of which develops the case for adopting SRI on the basis of its improvement to financial return.

(i) Academic Research

Existing academic empirical research has failed to find any statistically significant difference in the returns of socially responsible funds (for example, Mallin, Saadouni and Briston, 1995). Although this appears to be a negative result at face value, it actually represents a positive result for the pro-SRI lobby, as evidence showing no significant difference between ethical and non-ethical investment provides people with a costless choice of investing in a socially responsible manner. A number of empirical studies have been performed to evaluate the financial performance of UK socially responsible funds. Luther, Matatko and Corner (1992) isolated a sample of socially responsible unit trusts and found that five of the trusts offered a higher total return than the FT-All Share index. They found overall that half of the trusts studied outperformed the market and half underperformed. However, the use of an appropriate benchmark in such empirical work has raised concerns (see Luther and Matatko, 1994). Mallin, Saadouni and Briston (1995) attempted to overcome this problem by using improved techniques to compare the performance of UK SRI funds not only with a market benchmark but also with non-SRI funds. Overall, they found that both socially responsible and non-socially responsible trusts seemed to underperform the market. However, they provided some weak evidence that socially responsible trusts outperformed non-socially responsible trusts. They attributed their findings to a type of 'bandwagon' effect, *"The weakly superior performance of ethical funds evidenced in the sample may have been a temporary phenomenon caused by an increased awareness and interest in ethical investment. This in turn led to increasing levels of demand for appropriate investment products establishing a premium in realised rates of return. Indeed, this phenomenon may still be continuing as ethical investment gains in acceptance"* (p.495). Using similar techniques, the most recent econometric study on UK data, performed by Gregory, Matatko and Luther (1997) showed that both socially responsible and non-socially responsible trusts underperformed the market but that underperformance was worse for socially responsible trusts.

Although these findings are interesting they apply only to funds which are run solely on an ethical basis. As discussed earlier, the market has evolved now such that nearly all major funds take account of SEE issues in their portfolio investment decisions. Therefore, this sort of study is no longer applicable as there are no funds which could be termed completely 'non-ethical'. A different approach needs to be developed to discover whether SRI has a positive or a negative impact on investment return.

(ii) Development of SEE Benchmark Indices

From a more practical perspective, the development of benchmark indices for evaluating socially responsible fund performance should provide clarification on this issue. Williams (1999) stated that one of the future trends in UK SRI would be the development of dedicated performance benchmarks. Indeed, there has been a recent emergence of SRI stock exchange indices in the UK. EIRIS has developed five socially responsible indices, each of which indicates financial returns roughly equivalent to the FTSE-All Share Index for the period 1991 to 1998. Also, in 1998, the NPI Social Index was launched. It is likely that the emergence of new SRI indices will *"...explode the myth that green and ethical investors have to accept that their investment performance will be disappointing"* (Holden-Meehan, 1999, p.35). Indeed, in the last couple of years both the UK and the USA have developed new SRI benchmark indices, the Dow Jones Sustainability Indices (DJSI) in the USA and the FTSE4Good index in the UK. The first indications are that the DJSI is performing well and the market is anticipating similar news for the UK index (Martin, 2002).

(iii) The Risk-Based Approach to SRI

The institutional investment community in the UK has now acknowledged the potentially devastating effect that mismanagement of SEE issues can have on companies' reputation and hence on share prices and investment return. Following the publication of the Turnbull Report (1999) which provided recommendations to UK listed companies on how to operate an effective system of internal control, there has been an increasing awareness of the significance of non-financial (SEE) issues to financial performance. A report by the Association of Chartered Certified Accountants (ACCA) (2000) emphasised the importance of taking SEE issues into account within a Turnbull framework of risk management and internal control. As well as encouraging companies to develop improved risk management practices in the SEE area, the Turnbull Report (1999) has encouraged companies to disclose more information on their SEE liabilities and risk management procedures. Indeed, the Association of British Insurers (ABI) has developed a series of guidelines for listed companies on SEE disclosure, from a risk management perspective. A report commissioned by the Association of British Insurers (ABI) demonstrates that SRI reduces risks of financial loss and in fact adds to shareholder value (Cowe, 2001). The institutional investment community has recognised that SRI has moved from being a strategy based on companies' attempts to improve their marketing and personal relations to a serious approach based on avoidance and management of reputation risk (Montagnon, 2002). A risk-driven approach to SRI acknowledges the risk of substantial corporate financial losses arising from SEE mismanagement as,

> Reputation, in our view, will be a key competitive differentiator for the successful company for the next 50 years (ACCA, 2000, p.11).

It seems that shareholders are increasingly aware of the impact that reputation can have on shareholder value.

(iv) Cases of SEE Mismanagement and their Impact

The potentially devastating impact of corporate SEE mismanagement and abuse on share values and consequently upon investment returns has been recognised for some time. Damage to reputation arising from serious SEE incidents where internal controls and risks management in the SEE have been weak has been demonstrated unequivocally by a number of highly publicised cases. We now consider a umber of cases which provide anecdotal evidence that there is a significant relationship between CSR and financial performance and therefore between SRI and financial return to investment.

The environment is one of the most high profile areas of SEE concern for companies and investors in which there have been a number of notorious cases resulting in companies suffering substantial financial losses. One of the earliest and most influential cases was that of Exxon Valdez where the accidental sinking of an oil tanker resulted in extensive pollution of seawater in an area of outstanding natural beauty. This resulted in the company being targeted by environmental lobbyists, divestment by major institutions and a plummeting share price. It was this disaster which inspired the development of the Ceres Principles on corporate environmental reporting.

More recently, the decision by BP to dump an outdated oil platform sparked a furor environmental lobbyists. Greenpeace claimed that firstly the company had no right to discharge waste into the deep ocean and secondly, that this was not an environmentally acceptable means of disposing of the platform. After a period of mass media attention the company decided to dispose of the platform in an alternative way. However, scientific research undertaken by the company showed that deep ocean disposal was in fact a more environmentally sound approach, calling into question Greenpeace's judgement. Institutional investors refer to this case in their discussions of SEE issues and suggest that lobbyists are not always correct and that they should not always act on pressure from environmental/social lobby groups. However, the other main concern raised by lobbyists about this case still holds. The issue of whether or not a company has a right to make use of the ocean or any other natural resource in this way, when it does not belong to them, is an issue which is widely debated.

In the area of human rights, there have been a number of high profile cases where companies have been found to be operating 'sweat shops' in their foreign subsidiaries. There have been cases of child labour and abuse of employees' rights with workers operating in appalling conditions for excessively long hours. Nike is a prominent example. Again, the unleashing of information relating to these issues has resulted in swift and negative impacts on financial performance with shareholders divesting to register their dissatisfaction.

Enron too presents a poignant case for improved management and control of SEE issues. Not only has the company become a household name representing unethical business conduct and financial mismanagement but the company was also the perpetrator of serious human rights abuses several years before its ultimate demise. In the 1990s Enron was accused by human rights activists of hiring security guards to watch its facility in India who subsequently attacked and seriously harmed protestors from the local community who were demonstrating against the local impact of the site's operations. Not only does this indicate that Enron was demonstrating signs of ethical and social misconduct well before the events of 2001 but this case also indicates that SEE management is an indication of management quality. Indeed it is increasingly recognised that the manner in which company management deals with SEE risks and liabilities may be used by institutional fund managers and analysts as an indication of managerial quality and performance (Solomon and Solomon, 2002).

In the area of human rights and ethics, the decision by the Johannesburg Stock Exchange to force listed companies by law to disclose the number of their employees affected by the HIV virus is anecdotal evidence that mismanagement of SEE issues have a recognised and potentially negative impact on financial returns. Concerns that companies will be faced by unanticipated financial liabilities as a result of employees becoming ill have forced the Government to encourage listed companies to disclose information relating to infection as a potential liability.

Huntingdon Life Sciences (HLS) has demonstrated a clear and negative relationship between unethical behaviour in the area of animal rights and financial performance. Incidents of unacceptable abuse of animal rights at the Oxford site of HLS were exposed through videos taken by animal rights activists who infiltrated the company premises. These clips received mass media exposure and resulted in an outburst of activity by animal rights activists and lobbyists. The pressure on the UK financial community was so significant that all the institutional investors divested their shares in HLS. In the following months HLS managed to obtain financial backing from a major US financial institution but again in recent months this has also been withdrawn as a result of lobby pressure.

Clearly, these cases provide only anecdotal evidence that there is a substantial reputation risks attached to SEE mismanagement. However, the cases have been important enough to worry company management and the institutional investment community.

(v) The Positive Results of Engagement and Dialogue

Another reason why SRI seems to be growing is the positive impact which engagement and dialogue between institutional fund managers and their investee companies have had on financial performance and investment return. One traditional theoretical viewpoint on SRI is that any reduction in the investment universe through screening (i.e. exclusion of companies in 'unethical' industries) reduces the potential return to investment. This is inarguable and is couched in portfolio theory (Boatright, 1999). However this argument against SRI only applies to fund managers employing a screening strategy. The early ethical funds in the UK relied on screening and were individualised by their varying selection of ethical criteria. In the last few years, a completely different approach to SRI has evolved, with fund managers moving away from screening towards a strategy of engagement and dialogue. This means that institutional investors invest in shares across all industries but frequently select those that are 'best in sector'. In other words, companies are selected in all industries on the basis of the best performers in the SEE area. Also, if there are any concerns about a company's SEE-related behaviour the fund manager will engage directly with the company management in order to encourage a change in company policy. For example, Friends, Ivory and Sime, a large institutional investor which has now become 'Invensys', have been actually encouraging their investee companies in the clothing sector to develop policies on employees' rights in foreign subsidiaries and have forced them to disclose information relating to their activities in foreign countries (Litvack, 2002). The growing belief is that rather than restricting financial return to investment, this type of engagement approach actually enhances return by reducing the risk of reputation damage, thereby stabilising financial performance and in the long-run improving returns to investment. A series of in-depth interviews with UK fund managers and investment directors has revealed that the SEE engagement process in UK investment institutions is becoming formalised and is now largely integrated into the mainstream investment process (Solomon and Solomon, 2003).

(vi) Institutional Changes: The Evolving Role of Pension Fund Trustees in SRI

A seemingly minor institutional change to pension fund law has had a significant impact on pension fund trustees and on SRI in the UK. Since July 2000, an amendment to the Pensions Act (1995) has required all trustees of occupational and local government pension schemes to state their policy on the extent (if at all) to which social, environmental or ethical (SEE) considerations are taken into account in the selection, retention and realisation of investments. Therefore, although trustees are not forced to practise SRI, they are now required to state whether or not they do (EIRIS, 1999). Nevertheless, SRI is a difficult issue for trustees to deal with. Their fiduciary duty obliges them to maximise future pension receivables (Cunliffe, 1997; Ellison, 1997). This duty does not necessarily correspond to the potentially wider role in society that they may take on by adopting SRI. Assessing whether or not these roles conflict is essential for the future prosperity of pension fund members. Given the current situation, pension fund managers are not keen to risk an SRI policy which might damage returns (Pensions Week, 10 June 2002). Indeed, trustees are under extensive pressures due to the Myners Review (2001) which concluded that trustees did not possess the training and knowledge necessary for them to carry out their responsibilities effectively. Pressure to embrace SRI issues may be perceived as an additional burden which trustees cannot even consider bearing (Solomon, Solomon and Norton, 2002).

Indeed, the role of the trustee in SRI seems to be evolving gradually, with Solomon and Solomon (2003) finding evidence from questionnaire data and interviews that trustees are becoming more aware of, and interested in, SRI issues, despite concerns about their fiduciary duty. SRI issues were now included on the agenda at trustees' meetings, whereas they were generally omitted before. However, the paper identified a number of organisational and contextual factors affecting the level of interest in SRI among the trustee community. Indeed, they found statistical evidence that trustees from larger pension funds and those with a greater proportion of equity in their asset allocation, were more interested in SRI issues. Further, the paper showed how, hypothetically, this minor institutional change to pension fund law could lead to greater CSR, through a virtuous circle effect. Indeed, the new disclosure regulation for trustees has been found to have had a significant impact, as,

> This requirement [the new SRI disclosure requirement] has had a significant and wide-ranging impact on the investment community. The majority of trustees have incorporated reference to social, ethical and environmental (SEE) issues in their annual statements in 2001. Most of them have delegated responsibility for implementing this to fund managers which has added significantly to the growing Socially Responsible Investment (SRI) movement (Cowe, 2001, p.8).

It remains to be seen whether or not SRI will become more or less central to the trustee's role.

(vii) Sociological Factors

There are also a number of sociological factors which appear to have promoted the growth of SRI in the UK. For example, a general increase in ethicality in UK society and a desire to achieve a consensus on moral and ethical issues may be a factor leading to greater interest in SEE issues. Further, the growth in media exposure of all events, including those relating to SEE issues has sparked interest among the general public (and therefore pension fund members and other clients of investment institutions) in SEE and ethical investment. Another sociological factor contributing to the growth in SRI seems to be the heightened interest in risk and risk management. These sociological factors in the UK are discussed in relation to SRI in McCann, Solomon and Solomon (2003).

The Development of Socially Responsible Investment in Japan

In contrast with the UK experience, the first roots of SRI in Japan are considered to have emerged in 1999, with the introduction of 'eco-funds', investment funds which focus specifically on environmental issues. Table 1 summarises a series of events which have contributed to the development of SRI and CSR in Japan. Since August 1999, eleven SRI funds, including eight eco-funds, have been formed. SRI by pension funds is at a far earlier stage of development. However, the speed of change has accelerated since 2000. The Mutual Aid Association for Tokyo Metropolitan Teachers and Officials was exceptional, as they quickly took up investment in eco-funds and started to invest a small part of their fund into eco-funds in December 2000. This pension fund began to adopt SRI as an aspect of its in-house fund management in April 2003, soon after the Ministry of Education and Science had lifted ban on fund management of pension funds of teachers and officials associations of all authorized schools. New development of SRI has continued since then. At the end of July 2003, Sumitomo Trust Bank launched the first SRI fund for pension funds and two pension funds, belonging to KDDI and Shinsei Bank, decided to entrust with Sumitomo Trust Bank Yen 25 billion to the SRI fund. Nevertheless, the amount invested according to SRI criteria remains small and no other pension funds have adopted an explicit SRI policy to date. Also from Table 1, we can see that the Morning Star company started to publish SRI index in July 2003. They suggested that the SRI market in Japan was still at an early stage of development, but that its evolution was steady.

Insert Table 1 about here

A number of US and European SRI research-organisations have conducted questionnaire surveys of Japanese companies, in order to discover whether or not these companies have been approached for SEE information. However, many Japanese companies targeted in the domestic market declined to respond to these questionnaires, as they felt that they were based on Western ethics and Western ideas of social justice. They considered that the Japanese should discover their own solutions to CSR problems domestically. This is an extremely interesting issue as it shows that domestic Japanese companies adhere strictly to notions of ethical relativism, believing that different countries are associated with different sets of ethics and moral principles, and that one country should not attempt to inflict their ethical beliefs on another (Wong, 1991; Bowie, 2004). There was an extremely different response from companies conducting cross-border activities, as they appeared to be far more concerned about international perspectives on CSR. They are clearly likely to be more sympathetic to other cultural norms regarding ethics, as they need to conform in order to be internationally competitive. Since 1988, the Council for Better Corporate Citizenship (CBCC)[2] has been investigating SEE issues for multinational firms and international standards of CSR, since Japanese companies faced various conflicts with employees and local communities in the US in the 1980s.

Shareholder power is also relatively new in Japan. Indeed, Japanese institutional investors have only started to execute their voting rights since the end of the 1990s. This was partly a result of the major period of financial reform, named the 'Japanese Big Bang', which started in 1997. Furthermore, Japan is experiencing a rapid ageing of the population. Both the sustainability of society, as well as the restructuring of corporate management depends on the extent to which households shift their savings into the securities market. Not only pension fund managers but also their trustee bodies, which are trust banks and life insurance companies entrusted by pension funds and legal shareholders in the Japan's pension scheme,[3] are being pressured by society to improve investment performance. If they are asked to become more aware of SEE issues in their investee companies at the same time, this is a difficult path to tread and a hard balance to achieve.

As has been the case in the UK, in the near future, Japanese corporate pension funds are also going to be confronted with the problem of balancing their fiduciary responsibility against a consideration of SRI strategies.[4] It seems that engagement and dialogue may be acceptable measures of corporate governance for Japanese institutional investors, as both investors and companies like to cooperate their activities over the long-term. We discuss the current situation and potential development SRI in pension funds in Japan later in the paper.

CSR and SEE Issues in Japan

In Japan, SRI has remained an irrelevant issue until relatively recently. A number of high profile cases of corporate SEE mismanagement in the area of health and safety and ethics have drawn attention to SRI concerns. Japan does not have the religious background for ethical investment, found in Western countries such as the UK, although there has been, historically, a corporate culture of consideration to employees and regional community, with an emphasis on family and regional ties. Hence, it is likely that SRI, which encourages CSR through the capital market, has been less familiar with the general public in Japan than in the Western countries - at least until recently. This does not mean that Japanese society is unconcerned with SEE issues or that they do not perceive the financial markets as a means to solving SEE problems. In January 1991, the Postal Service Agency of the Government,[5] which has 16,000 subsidiaries across Japan, introduced Postal Savings for the International Volunteer Aid Program (see Table 1). According to this programme, 20% of savings incomes is dedicated to NGOs for medical, educational, agricultural and environmental activities in developing countries. These savings became popular among the households soon after they had started, such that the amount of donation continued to

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[2] CBCC was founded in September 1989 with full backing of Keidanren (Japan Business Federation) in order to solve the issues relating to the investment friction they faced in the U.S. and other markets. In June 1990, CBCC was authorised as a designated public-benefit organization.

[3] Suto (2002a) explained the Japanese pension funds scheme and government policy.

[4] A fund manager of Government Pension Investment Fund (GPIF)published his strong objection to SRI by pension funds as a personal viewpoint because social investment criteria are contradict to financial criteria. (Terada, 2003) GPIF is the largest pension fund in Japan.

[5] The Postal Services Agency was transformed into an independent government company in April 2003.

increase until the implementation of an extremely low interest rate policy during the prolonged economic depression. [6]

With respect to CSR, environmental problems have been particularly salient in Japan. Since the end of the 1980s, the Government established laws for environmental protection. In 1997, the Ministry of the Environment requested companies to publish environmental reports. This had a substantial impact. Indeed, the number of companies publishing environmental reports (including listed and unlisted companies) increased from 169 in 1997 to 579 in 2001. Further, the number of listed companies with established environmental management policies increased from 56.5% in 1998 to 71.4% in 2001 (Ministry of Environment, 2002a, chapter 2).

Further, CSR issues attracted the attention of the general public in 2001 following a number of high profile cases of SEE mismanagement by established companies in the area of health and safety, and ethics. In October 2001, the Ministry of Agriculture, Forestry and Fisheries of Japan implemented a policy to buy beef produced in areas where several cows had been discovered to have BSE. *Yukijirushi Food Company* and other foods companies committed fraud in order to sell imported beef to the government. Following the BSE scandal, other unethical activities by food companies were discovered, including deliberate mislabelling of when and where the meat was produced. This resulted in severe criticism by the general public, with consumers boycotting the companies' products. *Yukijirushi Food Company*, previously established as leader in the food industry for several decades, went into liquidation and was delisted from the stock market. Further, *Nihon Ham Company* lost 60 % of sales during a month. (Kawaguchi, 2002, p.9) Further in the Autumn of 2002, the leading electric power company, *Tokyo Electric Power*, was accused of running one of its nuclear power stations for a number of years, despite having undisclosed information relating to health and safety problems in the station.

Such cases of unethical behaviour by leading Japanese companies with hitherto immaculate reputations, triggered widespread demand for increased CSR, not only in the areas of health & safety, and the environment, but also in relation to ethics and compliance issues. Until then, Japanese society had never devoted attention to corporate SEE issues (except pollution), since they believed company reputation provided a true reflection of corporate behaviour. In response to the increasing demand for CSR within Japanese firms, Japan Business Federation (Nippon Keidanren)[7] revised its Charter of Corporate Behavior and published a set of guidelines for corporate ethics in October 2002, which urged its members to adhere to it, in order to recover public confidence in business. These guidelines focused on strengthening CEO initiatives for ethical behaviour, improvement of internal control, disclosure of policies on ethical management.[8] In advance of these guidelines, in May 2002, the Council for Better Corporate Citizenship (CBCC) published a report on the international standardisation of CSR which raised the possibility of legislation on CSR in Japan.

Clearly, Japanese companies have been confronting a substantial demand for CSR both domestically and from the international community. The recent cases of SEE mismanagement suggest that the self-disciplining mechanism in the Japanese corporate system has been working less efficiently than before. Further, the worst cases of unethical behaviour seem to have been associated with large, established companies, with a long history of Japanese management. This is a particularly worrying issue for Japanese society, given the traditional high level of trust invested in Japanese companies.

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[6] In 2001, about 26 million people participated the program and about ¥ 0.7 billion supported 132 NGOs.

[7] Japan Business federation was born as a new business community in May 2002 by amalgamation of two employers' associations, namely Japan Federation of Economic Organization and Japan Federation of Employers' Association.

[8] http://www.keidanren.or.jp.

The Japanese Government's Cabinet Office introduced guidelines for corporate compliance from the perspective of consumers in April 2002 and the Financial Services Agency published a report on disclosure of corporate governance issues including confirmation of the annual financial reports. This series of government policies could stimulate CSR disclosure by Japanese companies.

Development of Socially Responsible Investment Funds and Consumer Activism

In August 1999, the first SRI investment funds dedicated to corporate environmental issues (termed 'eco-funds'), were introduced by *Nikko Asset Management Company*. Within six months, four more eco-funds were introduced. By the end of February 2002, the number of SRI investment funds stood at eleven, including eight eco-funds and three social and eco-funds, with approximately 90% of their asset value held by individuals (Ministry of Environment, 2002b, p.55).

Insert Table 2 about here

As we can see from Table 2, at the end of October 2001, the total asset value of Japanese investment in SRI funds amounted to Yen133.5 billion (Euro 1140 million)[9] which represented a share of 0.8 % of stock investment funds in Japan. The absolute scale of SRI funds in Japan is not small in comparison to those of European countries. In Japan, investment funds amounted to only 2.5 % of the total assets in the household sector at the end of September 2001[10]. Therefore, despite growing interest in CSR and SEE issues, SRI was negligible in financial assets of the households sector. This is partly because investment funds have been traditionally marginal assets for households, given the bank-based financial system which has dominated in Japan. Also, spread of securities investment was curtailed in the prolonged stagnant market.

One problem associated with Japanese SRI funds has been their positive screening of environmental issues. A focus on the environment has stemmed not only from an interest in environmental protection due to globalisation of Japanese business in the 1990s, but also from a growing awareness of environmental problems within Japanese society, since the Japanese 'bubble' burst. Until then, corporate activities had been associated with environmental degradation, with little concern from consumers who were impressed by massive profitability in the bubble economy in the late 1980s. Eco-funds were made available to individual investors two years after the Japanese Financial Big Bang in 1997, when financial reform created a more market-oriented system, and households began to focus more on securities investment. Four eco-funds were established in 1999 and the amount of eco-funds was more than Yen 200 billion at its peak at the end of 1999 (Ministry of Environment, 2002b, p.55). Another eight funds were established from January 2000 and June 2001. Unfortunately, since then, the stock market continued to decline and eco-funds have also hovered at a low level.

Another problem with eco-funds has been their portfolio strategies. It is often highlighted that eco-funds are predominantly constituted from investment in leading companies such as *Sony* and *Matsushita*, which support their performance.[11] Thus, SRI funds in Japan are still minority in terms of quantity and immature in terms of screening. On the other hand, demand for CSR has been growing steadily in society, with a greater variety of SRI funds being available to Japanese

[9] The market value reduced to Yen 100 billion in July 2002 due to declining stock market.(Kawaguchi, 2002. p.131, Table 23)

[10] Financial assets held by household sector amounts yen 1454 trillion, including yen 37 trillion of investment trusts (Bank of Japan).

[11] For example, top ten stocks of Nikko Eco-fund shared 34.5% of total value of the fund are typical Japanese established companies including Toyota, NTT Docomo, HOYA, Fuji Film, Matsushita Electricity, Mitsui-Sumitomo Bank , Honda and others. Total number of the stocks contained in the fund is 82. (*Nikko Eco-fund Monthly Report*, the end of October 2002, http://www.nikko-am.co.jp/pdf.data/m_nk_eco_sp.pdf.)

households. Some experiments for SRI have also carried out on private portfolios.[12] SRI funds have begun to attract considerable attention from the general public and fund managers.

Pension Funds Reform and Shareholders Activism—Institutional Changes

In an ageing society, long-term institutional investors such as pension funds and life insurance companies play a key role in solving corporate SEE problems in the framework of corporate governance as leading shareholders. In Japan, institutional investors had been silent shareholders until recently in the bank-based financial system under the government policy to prioritise financial stability and order rather than competition in the financial services industry. As a consequence, trusteeship has been restricted to trust banks and life insurance companies, with no in-house fund management being permitted. In addition, the asset allocation of corporate pension funds has been strictly regulated, as corporate pension funds were designed in part to complement public pension funds. In this regulatory framework, there was no incentive for either corporate pension funds or their trustee bodies to be active shareholders as long as economic growth was sustained.

The situation changed after the 'bubble' burst. It became clear that the traditional system was not sustainable for a rapidly ageing society, with a lower level of economic growth. Pension fund reform started in the early 1990s, with deregulation of asset allocation, strengthened disclosure of fund management activities, and enhanced competition in pension fund trusteeship through the arrival of investment advisors (Suto, 2002a, pp. 261-264). In the late 1990s, the fiduciary responsibility of corporate pension funds became a key point for discussion in order to improve financial performance in the prolonged economic stagnation. Table 3 shows the process of institutional change in pension fund attitudes towards shareholder activism. The Ministry of Welfare introduced a set of guidelines for the fiduciary responsibility of corporate fund directors in 1997, after the regulation of asset allocation by corporate pension funds was eventually abolished.[13] Fiduciary responsibility of pension fund managers covers corporate governance of investee companies as well as accountability of fund management.

Insert Table 3 about here

However, in Japanese pension fund management schemes, ownership and legal rights to control companies are legally separated. Legal shareholders are trust banks and life insurance companies which are trustee bodies, although actual shareholders are their customers, pension funds. Pension funds themselves are not allowed to give instructions on individual investees to their trustees. So, except in-house management, there are no legal routes for pension funds directly to execute their shareholders rights. All shareholders’ rights are delegated to their trustee bodies, while the pension funds bear the ultimate investment risk. If a pension fund wants to commit corporate management as real shareholders in order to take fiduciary responsibility, they can show their fund management policy explicitly to trustee bodies and put pressure on them to take action as shareholders on behalf of customers. Following the liberalisation of financial services and the Ministry of Welfare's published guidelines on fiduciary responsibility of pension funds in 1997, trust banks and life insurance companies increasingly executed voting rights year by year in enhancing competition in the pension funds trustee business.

A questionnaire survey of corporate governance in Japanese corporate pension funds and their trustee bodies was carried on in January 2001(Omura, Suto and Masuko, 2001). The results revealed obvious changes in the attitudes of corporate pension funds and their trustee bodies toward more active shareholders in transition toward more market-oriented system 690 of 1193 pension funds (58%) and 68 of 88 trustee bodies (77%) considered that trustee bodies should

[12] In February 2002, a social entrepreneur fund in limited partnership was organized by Mirai Securities Company. That is SRI fund to explore unpublished firms with positive social screening.

[13] Pension fund of Cooperative Association of Private Schools and Universities has been under the regulation of the Ministry of Education. The regulation on assets allocation was abolished in April 2002.

execute voting rights as agents of pension funds. Another institutional change to stimulate corporate pension funds as active shareholders was introduction of defined contribution plan, named the Japanese 401K. The DC plan has been gradually adopted by corporate pension funds since it started in October 2001. Though the number of companies which adopted the DC plan was only 203 and about 10% of listed companies at the end of 2002, it was expected to enhance beneficiaries' consciousness as active shareholders and give them a stronger incentive to monitor pension fund managers.

Actually, pension funds trustees bodies and in-house managers of the Pension Fund Association began to demonstrate their agreement and disagreement through voting and blank voting decreased dramatically in 2002, as Table 4 shows. This trend is more conspicuous for fund-management by corporate pension fund associations, as evidence by Table 5. They disagreed with one fourth of the proposals at corporate general shareholder meetings. In this new movement, the Pension Fund Association has increasingly led shareholder activism in Japan. According to interviews which the Association conducted after the general shareholders meetings of Japanese companies concentrated in June, they were told that the reason for a high level of votes 'against' management was that the corporate mangers had not answered their questions adequately. They also commented that the concentration of certain groups at the general shareholders meeting was a major barrier to shareholder activism in Japan.

Insert Tables 4 and 5 about here

While the conventional Japanese-style corporate governance, characterised by monitoring by main banks and internal disciplining by life-time employment with career concerns, has been reducing its function in the 1990s, institutional investors have been seeking more active involvement in corporate management. Facing corporate SEE issues in the 2000s, institutional investors should have considered SRI and CSR in taking fiduciary responsibility as agents of individuals. SRI by pension funds has not been put into practice yet but pension fund managers are facing strong demands for improved investment performance by enriching their fund management competencies rather than developing SRI at the moment. However, it is reality that pension funds managers in general are not concerned SRI and rather strongly question about harmonization between fiduciary responsibility and social screening investee companies.[14]

Both pension fund managers and their trustee bodies do not seem to recognise the linkage between corporate SEE issues and investment risks sufficiently in Japan. They realise that the execution of shareholder rights is a part of their fiduciary responsibility but CSR issues are not related to their corporate governance activities. They should commit harmonisation of fiduciary responsibility and financial performance considering CSR more explicitly so as to reduce investment risks in the long-run. Engagement and dialogue would be an acceptable measure of corporate governance for the institutional investors in Japan, where both investors and companies prefer collaboration to conflict in the markets in establishing relationships.

However, as mentioned earlier, the first socially responsible investment by pension funds appeared in April 2003. The Teachers Aid Association for Tokyo Metropolitan Teachers and Officials launched to manage a SRI portfolio screened with educational, environmental and gender criteria. At the end of July 2003, Sumitomo Trust Bank launched the first SRI fund for two pension funds, KDDI and Shinsei Bank.[15] These are still very exceptional but it makes us

[14] A fund manager of Government Pension Investment Fund (GPIF)published his strong objection to SRI by pension funds as a personal viewpoint because social investment criteria are contradict to financial criteria. (Terada, 2003) GPIF is the largest pension fund in Japan.

[15] It is announced that the SRI fund screens 250-300 investees based on CSR criteria and among them further screens based on financial performance to 70-80 investees finally. The final portfolio includes Matsusita Electric Company, JR, TOTO.

expect a new development of pension funds management focusing on corporate social responsibility of investee companies.

Improvement in Disclosure of Corporate Governance and Risk Management

Responding to corporate SEE issues in Japan, improvement of corporate disclosure is indispensable from the viewpoint of public policy. The Financial Services Agency (FSA) started to review disclosures focusing on internal governance and corporate risks in October 2002. There is an international trend to strengthen disclosure of governance information related to internal control, risk management, and remunerations of managers. Risk information disclosure has been unsatisfactory for investors' decision- making in Japan. Disclosure of remuneration of Japanese corporate managers has not been concerned by the investors as well as managers themselves because it is well known that they are much less than the US, the UK and any other countries, though international investors are concerned with it.

The FSA published Disclosure Working Group Report in December 2002, which says governance information and risk information should be mentioned in each section independently and clearly, and recommends COE to confirm disclosure report for appropriateness of the contents. These disclosures are voluntary base with no legal obligation or penalty, and the government keeps a stance to solve CSR problems in natural selection process of capital market. This is just epoch-making improvement of for Japanese corporate disclosure because it explicitly mentions that corporate managers have to be responsible for disclosure of internal governance system including risk management. Implicitly it suggests that corporate risks they manage and disclose include social risks that the company faces.

New Development of SRI Indexes

With further corporate scandals arising in Autumn of 2001, a trend of social assessment of corporate behaviour has become more apparent in Japan, accompanied by an increasing demand for social and ethical benchmarks to assess companies. In July 2001, Reitaku University Business Ethics & Compliance Research Centre developed criteria of corporate valuation focusing on compliance named R-BEC001. In November 2002, Morningstar, which is a rating company for investment trusts, announced a new project to provide an SRI stock market index, in cooperation with one of NPOs (non-profit organizations) think tank, the Public Resource Centre[16]. This SRI index is screened by criteria selected in five fields of CSR: 1. governance and accountability (governance, compliance, disclosure etc.); 2. market (attitudes to consumers, attitudes to trading partners, customers' satisfaction, procurement etc.); 3. employment(employment relations, human resources, human rights etc.); 4. social contribution (contribution to regional society, cooperation with NGOs etc.); 5. environment(environment management, protection of regional/global environment etc.).

As discussed above, in July 2003, a mainstream rating company, Morningstar started to publish a SRI index, MS-SRI. These SRI benchmarks for Japanese firms have not widely acknowledged by both corporate pension funds and among individual investors yet but future development seems to be promising.

The Future Route for Socially Responsible Investment in Japan and the UK: A Discussion

In the UK, it is widely recognised that management of corporate SEE issues is part of companies' internal control and risk management systems, so that long-term institutional investors should promote CSR in the framework of corporate governance by shareholders as agents of their customers as well as representative stakeholders of investee companies. They could contribute to

[16] Press release by Morningstar, '

increasing long-term benefits for their customers as well as those of the society as a whole. Thus, disclosure of SRI policy of the pension funds is a public policy for promoting CSR through natural selection in the market, because SRI by institutional investors is expected to be a driving force in realising socially responsible corporate activities. The use of corporate governance mechanisms such as engagement and dialogue by large shareholders to solve SEE problems is a realistic route for the development of SRI in Japan, which faces a rapidly aging society. However, there are some ways in which Japan can learn lessons from the UK experience in SRI.

Firstly, disclosure of SRI strategies of pension funds seems to contribute to enhancing consciousness about the responsibility of shareholders for social and environmental outcomes of corporate activities that they indirectly invest in, but it does not seem realistic to be implemented successfully at least in near future. According to experience of the UK, the reason why SRI disclosure policy is successful depends on a wide range of non-profits organisations which play important role as SRI information intermediaries, which link CSR demands with SRI drivers, and finally supply of CSR by corporate managers. Development of such neutral intermediation is a determinant to promote SRI and CSR if the government chooses to solve SEE mismanagement basically by market mechanism. While, development of NPO and NGO information intermediaries are developed much less sufficiently in Japan.

Secondly, in the case of Japan, professional fund managers of trustee bodies, which are trust banks, life insurance companies investment adviser companies, would play more important role to promote SRI by pension for Japanese pension funds more highly depend on external fund managers, though the UK experience suggests that development of SRI depends on not only ability of pension funds managers but also main stream asset management industry in general.

Thirdly, hence, it might be more effective in Japan to implement a public policy for the firms to disclose SEE issues as a part of internal risk management rather than to implement a policy for long-term institutional investors to disclose SRI strategies. Disclosure of SEE policy of firms will give explicit information of their attitude about corporate risk management. As less sufficient development of SEE intermediaries and less matured pension funds managers than the UK, the trustee bodies of Japanese pension funds could be actively execute shareholders' rights based on explicit SEE information disclosed by investees so as to assess corporate value in a long perspective.

What about a recommendation based on the SRI disclosure regulation for trustees? The deregulation has allowed trustees more freedom in asset allocation decisions. In Japan, this freedom could be used to improve decision and communication links between the pension fund members (society), the trustee bodies and the pension fund managers in order to experiment with, and build on, the positive financial benefits of an SRI policy.

Also, the benefits of engagement over screening need to be emphasised and applied in Japan. Screening in now an outdated form of SRI in the UK and should be sidelined in Japan in order to make way for SRI investment overlay strategies across all major pooled funds.

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Table 1
Events Contributing to the Development of Corporate Social Responsibility and Socially Responsible Investment in Japan

Date	Event
1989	The Council for Better Corporate Citizenship (CBCC) was founded with full backing of the Japan Federation of Economic Organization
1991	The Postal Service Agency of the Government started savings for the International Volunteer Aid Program (January)
1999	The Mutual Aid Association for Tokyo Metropolitan Teachers and Officials published a statement on the investigation of investment in eco-funds (February) The first eco-fund was issued (August) ECS2000 (Ethics Compliance Standard) was published from the Business Ethics & Compliance Centre, Reitaku University
2000	The first SRI investment fund was issued specialising in environmental and social issues (September) The pension fund of the Teachers Association of Tokyo started to invest approximately Yen 1 billion in eco-funds (December)
2002	CBCC published a report on the international standardisation of CSR (May) The Japan Business Federation revised its Charter of Corporate Behavior and the accompanying guidelines (October)
2003	The Mutual Aid Association for Tokyo Metropolitan Teachers and officials started to manage part of its pension fund according to SRI criteria, by screening 100 companies based on its own SEE standards, Yen 2 billion from Yen 8.4 billion total assets (April) The Morning Star started to publish an SRI index (MS-SRI), screening 150 company shares (July) Sumitomo Trust Bank launched the first SRI fund for pension funds, which was entrusted Yen 25 billion by the pension funds of KDDI and Shinsei Bank (July)

Table 2
International Comparison of Investment in Socially Responsible Investment Funds in 2001

		Number	Euros (millions)	%
Germany		22	838	0.10
France		38	1917	0.22
Italy		9	1842	0.43
UK		62	5910	1.03
Netherlands		16	989	1.45
Belgium		33	1683	1.18
Swaziland		16	1368	1.47
Total[1]		196	15663	0.43
Japan[2]		11	1140	0.80

Sources:
SRI Group, "Green social and ethical funds in Europe 2001" (www.srigroup.org)
Japan Investment Fund Association, Kawaguchi (2002)

Notes:
1. UC ITS funds in Europe
The asset values were calculated at the end of June, 2001
2. SRI funds in Japan were calculated at the end of October 2001 (Kawaguchi, 2002, Table 23)
The share is in the total amount of stock investment funds at the end of 2001.
The exchange rate was Euro 1: Yen 117.1

Table 3
The Development of Shareholder Activism by Pension Funds in Japan

Date	Event
1996	Partial relaxation of asset allocation regulation on pension funds
1997	Ministry of Welfare published guidelines for fiduciary responsibility of pension funds
1998	Abolition of regulation on asset allocation of pension funds
1999	The Pension Fund Association published basic policy for execution of voting rights
2000	Disclosure of net debts of pension funds on balance sheets of sponsor companies
2001	The 401k-type DC Plan was introduced (October)
2002	The Pension Fund Association released "Working Guidelines for the Exercise of Voting Rights"
2003	The Pension Fund Association published corporate governance criteria and started to execute voting rights on in-house investment

Table 4
Execution of Voting Rights in Japan
(2001 April-June; 2002, April-June)

	Number of Proposals		**%**
2001	Total	21206	100.0
	Agree	10772	50.8
	Disagree	358	1.7
	Carte blanche	10037	47.3
	Abstain	39	0.2
2002	Total	34536	100.0
	Agree	31499	91.2
	Disagree	1160	3.4
	Carte blanche	522	1.5
	Abstain	1355	3.9
	Proposals from Shareholders		
	Total	1041	100.0
	Agree	38	3.7
	Disagree	764	73.4
	Carte blanche	199	19.1
	Abstain	40	3.8

Source: Ministry of Health, Labor and Welfare
Notes: Excluding package reaction to a company

Table 5
Execution of Voting Rights by Corporate Pension Funds
(2002, July-March)

Number of Proposals		**%**
Total	970	100.0
Agree	732	75.5
Disagree	234	24.1
Carte blanche	0	0.0
Abstain	0	0.0
Number of companies	212	

Source: Pension Fund Federation
Notes: In-house investments by Pension Fund Association