A Rough Look at the MSCI ESG Rating System

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As the CPC Central Committee proposed the goal to peak carbon emissions and achieve carbon neutrality (the dual carbon goal) and sustainable development became an issue of global concern, enterprises, investors, and financial institutions all over the world have reached a consensus about paying close attention to environmental performance and social responsibility in their economic and social activities. The ESG concept has been widely recognized in the market. It is built on the environmental, social and corporate governance pillars, the most important three criteria used to measure the sustainability of economic entities by the international community. Mainstream institutions such as MSCI, Thomson Reuters, and FTSE Russell have established their ESG rating systems to provide investors with decision-making support. According to the latest MSCI ESG ratings, CCB was awarded "A", the highest level in the Chinese banking industry. The Bank, therefore, saw its corporate image in the international community further improved. As a large state-owned bank, CCB should not only closely follow up with its own ESG performance, but also integrate ESG-related factors into its investment and financing activities. In doing so, it aims to steer its customers towards sustainable development and help achieve the dual carbon goal. The purpose of this paper is to study MSCI's ESG rating methodology and provide some insights and references for building an ESG rating system that meets the needs of CCB.

I. MSCI's ESG Rating Process and Methodology

ESG is an acronym for Environmental, Social, and Corporate Governance, which are the three most important criteria used to measure the sustainability of economic entities by the international community. As a pioneer in ESG research, MSCI has seen its ESG ratings extensively accepted and used across the global capital market. A combination of qualitative and quantitative approaches is used by the leading provider of critical decision support tools to rate enterprises in an ESG term through main processes such as determining key issues and their weights, evaluating key issues, and obtaining ESG rating results.

i. Determining key issues and their weights in light of industry characteristics

MSCI evaluates the ESG-related performance of companies using more than 1,000 sub-issues under 37 key issues that unfold around ten themes. The ten themes include climate change, natural resources, pollution & waste, and environmental opportunities (environmental pillar); human capital, product liability, stakeholder opposition, and social opportunities (social pillar); and corporate governance and corporate behavior (governance pillar).

Table 1 Key Metrics of MSCI ESG Rating

3 Pillars	10 Themes	37 ESG Key Issues	
Environment	Climate Change	Carbon Emissions	Financing Environmental Impact
		Carbon Footprint per Unit Product	Climate Change Vulnerability
	Natural Resources	Water Stress	Rare Metal Sourcing
		Biodiversity & Land Use	
	Pollution & Waste	Toxic Emissions & Waste	Electronic Waste
		Packaging Material & Waste	
	Environmental Opportunities	Opportunities in Clean Tech	Opportunities in Renewable Energy
		Opportunities in Green Building	
Social	Human Capital	Labor Management	Human Capital Development
		Health & Safety	Supply Chain Labor Standards
	Product Liability	Product Safety & Quality	Privacy & Data Security
		Chemical Safety	Due Diligence
		Financial Product Safety	Health & Demographic Risk
	Stakeholder Opposition	Controversial Sourcing	
	Social Opportunities	Access to Communications	Access to Health Care
		Access to Finance	Opportunities in Nutrition & Health
Governance	Corporate Governance	Board	Ownership
		Pay	Accounting and Auditing
	Corporate Behavior	Business Ethics	Corruption & Instability
		Anti-Competitive Practices	Financial System Instability
		Tax Transparency	

Since the key risks and opportunities faced by different industries vary heavily, MSCI classifies companies into the Global Industry Classification Standard (GICS) sub-industries when setting key issues, selects metrics that well reflect the current status of ESG development given the characteristics of different industries to evaluate companies in each industry, and constructs ESG rating models in an industry-specific way. MSCI adjusts the key issues of each industry in November of each year to ensure the effectiveness of its rating system.

MSCI assigns a weight of 5-30% to each key issue according to the relevant rules. The weighting level mainly examines the degree of impact of a key issue on the specific industry and the duration of such impact.

ii. Evaluating key issues with the help of quantitative data and expert database

MSCI has established a rigorous rating framework and methodology for assessing each of the four key issue categories: risks, opportunities, controversies, and corporate governance, to ensure the comprehensiveness and comparability of key issue assessment.

1. Risks

In assessing ESG risk metrics, MSCI takes into account a company's risk exposure and risk management. Risk exposure indicates the severity of risks faced by a company from ESG key issues, and risk management measures a company's ability to take effective measures and avoid relevant risks. A company with high exposure must have very strong management to score as well as another company with lower exposure than it.

When assessing a company's risk exposure, MSCI considers its core product or business segments, locations of operations, forms of production, and reliance on government contracts. In the assessment of risk management, particular attention should be paid to not only practical evidence such as risk management policies and actions taken, but also outcome evidence such as trends in performance. In addition, controversies occurring within the last three years lead to a deduction from the overall management score on each issue. Scores deducted vary according to the severity of controversies.

2. Opportunities

When assessing a company's ESG opportunities, MSCI takes into account exposure and management. Exposure indicates the extent of opportunities faced by a company, which is usually relevant to the business and geographic segments of the company. Management examines whether a company can accurately capture and benefit from opportunities. When two companies face the same opportunities, that with better management capabilities will score better.

3. Controversies

A controversy case is defined as an instance or ongoing situation in which company operations and/or products allegedly have a negative environmental, social, and/or governance impact. From the perspective of stakeholders, MSCI classifies controversies into 28 themes under five major categories: environment, customers, human rights and community, labor rights and supply chain, and governance.

Combined with public opinion, MSCI assesses a controversy according to the severity of its impact on society or gives it a rating (very severe, severe, moderate or minor). Controversy cases that are widespread in impact and severe in nature usually receive a poor rating.

4. Corporate governance

Governance is divided into two themes: corporate governance and corporate behavior. Corporate governance is designed to comprehensively examine the performance of a company in four aspects: Board, pay, ownership, and accounting. It involves a total of 96 governance and accounting sub-issues. Corporate behavior focuses on inspecting a company's performance in moral integrity and tax payment.

iii. ESG ratings adjusted relative to industry peers

For a company, the absolute ESG score is calculated based on the scores and weights of key issues, and then adjusted according to the relative scores within the industry to obtain the ESG rating result of the company relative to industry peers. ESG rating results are not comparable among different industries.

II. Problems Existing in the Use of MSCI ESG Ratings in the Banking Industry

i. A limited number of enterprises covered

Only about 800 Chinese enterprises have received an MSCI ESG rating, and all of them are listed companies. In contrast, banks have a large number of credit customers, most of which are unlisted companies. Therefore, it is difficult for banks to identify green, low-carbon, and sustainable customers by using the ESG rating system.

ii. Chinese enterprises rated low overall

The reality is that 60% of Chinese enterprises with MSCI ESG ratings are in a backward position in their respective industry. This is largely because MSCI's ESG rating indices are mainly based on the national conditions and values of the developed European countries and the USA, and the key issues selected are not in line with the characteristics of China's economic and social development at the current stage. Compared with their Chinese counterparts, enterprises in developed countries started to value their ESG performance earlier and could disclose information in a more transparent and comprehensive way.

iii. ESG rating results are non-comparable in different industries

MSCI only provides the rankings of companies by ESG performance relative to industry peers. It is not possible to compare the ESG performance of companies in different industries. So MSCI ESG ratings can be applied to a limited scope. Banks need to know the ESG performance-based rankings of companies both within an industry and among different industries, which is a prerequisite for formulating risk appetite and adjusting credit structure.

III. Construct an ESG Rating Model that Meets the Needs of CCB

i. Use big data to expand the scope of enterprises covered by ESG ratings

CCB will capitalize on big data technology to expand the scope of enterprises covered by ESG ratings, by making the best of its massive amount of real customer data, including the basic information, financial data, credit records, transaction activities, and risk mitigation measures of corporate customers stored in the internal data system, as well as the data from external sources such as public data disclosed by enterprises, authoritative government platforms, and integrated data providers.

ii. Construct industry-specific ESG rating models

Since different industries face varying levels of ESG risk, it is difficult to accurately measure the characteristics of enterprises from different industries by using one set of assessment metrics. Instead, CCB will draw upon the advanced experience of MSCI in constructing industry-specific ESG rating models, and nail down key issues that have great impact on different industries to accurately measure the sustainability of enterprises.

iii. Establish a mechanism to make inter-industry comparison of ESG ratings

CCB will analyze and examine the regulatory policies, externalities, risks of corporate non-compliance, and operating costs in different industries. Relying on the data on corporate characteristics, the Bank will construct an industry-specific ESG risk assessment framework that combines the top-down and bottom-up approaches and develop supporting tools to form industry-specific ESG risk assessment models, in the hopes of boosting its ability to identify industry-specific ESG risk.

iv. Fully consider the characteristics of China's economic and social development

Given that China differs from the European and American markets in terms of development stage, values, and culture, MSCI's ESG indices and weights are inapplicable to some extent in China. While learning from foreign models, CCB should stress trade-offs and innovations. Keenly aware of the characteristics of China amid the industrial upgrading and transition drive, it will establish an ESG rating framework highly aligned with the national conditions, in an effort to accurately measure the sustainability of enterprises, channel financial resources towards the fields of green development, and facilitate the realization of the dual carbon goal.

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