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# Update to the Consultation on MSCI Global ESG Index Methodology

April 2012

# MSCI Global ESG Indices Consultation – Key Updates

- MSCI launched a consultation on proposed enhancements to the MSCI Global ESG Indices on January 23, 2012.
- This updated consultation document incorporates the client feedback received so far as part of the consultation. The key updates to the earlier version are highlighted below, while the rest of the document describes the proposed enhancements in further detail
- Methodology
  - MSCI proposes to use a combination of two MSCI ESG Research products for the purpose of index creation – IVA ratings for overall best-in-class ESG company performance and Impact Monitor scores for identifying highly controversial company practices and business activities.
  - Companies with major business involvement in the production of products with high negative social or environmental impacts will also be captured now as part of their Impact Monitor assessment. Consequently, the ESG Screener will not be used in the construction of the MSCI Global ESG Indices
- Transition Timeline
  - Based on client feedback, MSCI will not transition to the enhanced methodology in May 2012 Index Review. MSCI proposes to transition to the enhanced methodology at the May 2013 Index Review.
  - MSCI is considering providing provisional MSCI Global ESG indices, which will be based on the enhanced methodology starting from the May 2012 Index Review

# Executive Summary

- The MSCI Global ESG Indices methodology is currently based on the Global Socrates (GS) ESG ratings. MSCI intends to migrate these indices to an enhanced methodology based on a new suite of MSCI ESG Research products available on MSCI ESG Research's new platform - ESG Manager - to increase transparency and granularity of the ESG signals while keeping the philosophy underpinning the indices unchanged. Consequently, the impact of the enhancement on the existing indices is likely to be relatively marginal.
- MSCI proposes to use a combination of two MSCI ESG Research products for the purpose of index creation – IVA ratings for overall best-in-class ESG company performance and Impact Monitor scores for identifying highly controversial company practices
- In addition, MSCI proposes the following changes to the existing MSCI Global ESG Indices methodology and is seeking feedback on these proposed additional enhancements
  - Minimum Entry rating for a non index constituent in the MSCI Global ESG Indices would be increased from 'B' to 'BB'.
  - "AA" rated companies would be given preference in the buffer rules for selecting 50% free float adjusted market capitalization for every sector (currently "A" rated companies are given preference in the buffer rules)
- Please note this consultation may or may not lead to the adoption, in whole or in part, of the proposed enhancements described herein.

# Current MSCI Global ESG Indices Methodology

- Currently, the MSCI Global ESG Indices are based on Global Socrates ratings.
- The rebalancing results are announced five days before the effective date through Integrated Client File (ICF) and a Global Summary Document.
- An annual index review is done in May, coinciding with the May Semi-Annual Index Review of the MSCI equity indices (herein, “Parent Indices”). The indices are also reviewed on a quarterly basis to coincide with Semi-Annual Index Review in November and Quarterly Index Review in February and August.
- All constituents of the MSCI Global Investable Market Indices having a company level rating of “B” or above are eligible for inclusion in the MSCI Global ESG Indices.
- At each annual index review, the composition of the index is reassessed in order to target 50% free float-adjusted cumulative market capitalization of each sector of the underlying MSCI Parent Index. Buffer rules are applied in the following order to minimize turnover:
  - Companies in the top 35%
  - ‘A’ rated companies in the top 50%
  - Current index constituents in the top 65%
  - Remaining companies in the eligible universe
- At the quarterly index reviews, any existing index constituent whose rating falls to “CCC” or lower is deleted from the MSCI Global ESG Indices. Additions to the indices are only considered in those sectors where the resulting free float adjusted market capitalization coverage does not meet the 50% target with 10% buffer.

# Proposed enhancements

- MSCI ESG Research has introduced a new ESG research platform – ESG Manager. This platform provides products with two distinct ESG signals – overall ESG assessments (IVA ratings) and screening for controversial practices (Impact Monitor).
- The MSCI Global ESG Index construction approach uses:
  - A rating system for ranking companies in descending order of ESG quality;
  - Exclusions based on ESG controversies and highly controversial practices.
- Currently the MSCI Global ESG Indices are based on the Global Socrates ratings which bundles both ESG management performance and penalties for controversial practices and business activity into one single rating.
- MSCI proposes to unbundle the above and use two different indicators to reflect the underlying philosophy of the MSCI Global ESG Indices:
  - IVA Ratings : for overall, best-in-class company ESG ratings.
    - Select the “Best in Class” by sector.
  - Impact Monitor: assessment of company involvement in specific ESG controversies.
    - Avoid companies engaged in very severe and severe ESG controversies .
    - All existing constituents with an Impact Monitor controversy assessment of very severe will be excluded from the MSCI Global ESG Index. All non-index constituents with an Impact Monitor controversy assessment of very severe or severe/structural will be excluded from the MSCI Global ESG Index.

## Proposed enhancements (continued)

- The MSCI Global ESG Indices serve as benchmark for sustainable funds as well as for creating passive products aiming to provide best in class, sustainability options.
- The combination of the IVA ESG ratings and Impact Monitor signals retains the broad philosophy underlying the MSCI Global ESG Indices of “Best in Class” and assessing controversies while rendering more transparency and granularity to the MSCI Global ESG Indices as the impact of both of these indicators can be attributed individually.
- The IVA ESG ratings are based on a more powerful and more in-depth ESG research model compared to Global Socrates ESG ratings. This enhancement would make the MSCI Global ESG Indices a more robust benchmark of best-in-class sustainability performance.
  - IVA ESG ratings focus *exclusively* on the key issues affecting each industry.
  - IVA ESG ratings employ a thorough set of exposure metrics that improve peer comparisons significantly.
  - Designed to complement conventional analysis of companies’ financial performance, by providing an additional perspective based on sustainability factors .

## Other Proposed enhancements

- IVA ratings are based on a 7 point scale, 'AAA' - 'CCC' while the Global Socrates ratings are based on a 9 point scale, 'AAA' – 'C'. Since the IVA ratings system has a different ratings' scale compared to Global Socrates ratings, a higher minimum entry rule would be applied along with a higher buffer threshold for rebalancing.
- A higher minimum entry rule would also avoid excessive movement in index constituents due to minor changes in the rating of a company. A non index constituent must achieve a 'BB' rating to become eligible for inclusion in the index. An existing index constituent would remain in the index unless it is rated 'CCC'.
- The following buffer rules would be applied for selecting 50% sector coverage by cumulative free float adjusted market capitalization:
  - Companies in the top 35%
  - 'AA' rated companies in the top 50%
  - Current Index Constituents in the top 65%
  - Remaining companies in the eligible universe.

# Transition Analysis



# Proposal for transition to enhanced methodology

- MSCI proposes to transition of the MSCI Global ESG Indices to the enhanced methodology in May 2013 Index Review.
- Transition analysis for May 2013 Index Review using the enhanced methodology based on the data as of the close of November 30 2011.
  - Turnover for the proposed MSCI World ESG Index would be 7.6%
  - Comparable to the annual reconstitution turnover of 7.1% in May 2011 Index Review and the historical average of approximately 10%

## Pro forma Summary changes for MSCI World ESG Index In May 2013 Index Review

	# Current	# Pro forma	# additions	# deletions	Turnover
World ESG	795	827	113	81	7.6%

\* Based on enhanced methodology

## Pro forma Summary changes for MSCI USA IMI ESG Index in May 2013 Index Review

	# Current	# Pro forma	# additions	# deletions	Turnover
USA IMI ESG	1232	1260	55	27	3.9%
USA ESG *	313	319	25	19	4.3%
USA Small Cap ESG**	919	941	30	8	2.6%

\* Based on enhanced methodology

\*\* Based on current methodology

# Top Additions to MSCI World ESG Index (based on enhanced methodology)

Name	Country Name	Region	Sector	GS rating*	Impact Monitor Rating	Impact Monitor Score	IVA rating	Weight
Allianz	GERMANY	EU	Financials	BBB	Yellow	4	AAA	0.41%
Wesfarmers	AUSTRALIA	PA	Consumer Staples	BBB	Green	5	BBB	0.30%
Celgene Corp	USA	US	Health Care	BBB	Green	5	BBB	0.27%
ING Groep	NETHERLANDS	EU	Financials	A	Green	5	A	0.26%
Centrica	UNITED KINGDOM	EU	Utilities	BBB	Green	5	AA	0.22%
Viacom B (New)	USA	US	Consumer Discretionary	BBB	Yellow	4	BBB	0.22%
BT Group	UNITED KINGDOM	EU	Telecommunication Services	A	Green	5	AAA	0.21%
AXA	FRANCE	EU	Financials	A	Green	5	A	0.21%
Williams Cos	USA	US	Energy	BB	Yellow	3	BB	0.17%
Tokio Marine Holdings	JAPAN	PA	Financials	AA	Green	10	A	0.16%
Equity Residential	USA	US	Financials	B	Green	5	BBB	0.15%
Hong Kong Exch.&Clearing	HONG KONG	PA	Financials	BB	Green	8	AA	0.15%
Marsh & McLennan Cos	USA	US	Financials	A	Yellow	4	BBB	0.15%
QBE Insurance Group	AUSTRALIA	PA	Financials	BBB	Green	5	AA	0.15%
Fresenius Med. Care St	GERMANY	EU	Health Care	A	Green	5	AA	0.13%
Encana Corp	CANADA	CA	Energy	BBB	Yellow	4	A	0.13%
Holcim	SWITZERLAND	EU	Materials	BBB	Yellow	4	AAA	0.13%
Alexion Pharmaceuticals	USA	US	Health Care	BBB	Green	8	A	0.11%
Avalonbay Communities	USA	US	Financials	B	Green	5	BBB	0.11%
PPR	FRANCE	EU	Consumer Discretionary	BBB	Green	5	AA	0.10%
Reed Elsevier (GB)	UNITED KINGDOM	EU	Consumer Discretionary	A	Yellow	4	AA	0.09%
Legal & General Group	UNITED KINGDOM	EU	Financials	BBB	Green	8	A	0.09%
Cerner Corp	USA	US	Health Care	BBB	Green	10	A	0.08%
Shoppers Drug Mart Corp	CANADA	CA	Consumer Staples	BBB	Green	5	AAA	0.08%
Weyerhaeuser Co	USA	US	Financials	BB	Yellow	3	A	0.08%
Quest Diagnostics	USA	US	Health Care	A	Yellow	4	A	0.08%
Tokyo Electron	JAPAN	PA	Information Technology	BBB	Green	10	AAA	0.08%
AP Moller Maersk B	DENMARK	EU	Industrials	A	Yellow	3	AAA	0.08%
Resona Holdings	JAPAN	PA	Financials	A	Green	10	A	0.08%

\* GS (Global Socrates) rating is a bundling of ESG performance and highly controversial business activities represented by Impact Monitor Ratings

# Top Deletions from MSCI World ESG Index (based on enhanced methodology)

Name	Country Name	Region	Sector	GS rating*	Impact Monitor	Impact Monitor Score	IVA rating	Weight
Banco Santander	SPAIN	EU	Financials	A	Yellow	3	BB	0.59%
Mitsubishi UFJ Fin Grp	JAPAN	PA	Financials	AA	Green	7	BB	0.51%
Simon Property Group	USA	NA	Financials	BB	Yellow	4	B	0.34%
Baxter International	USA	NA	Health Care	A	Yellow	2	B	0.28%
Richemont (fin) a	SWITZERLAND	EU	Consumer Discretionary	AA	Green	8	BBB	0.26%
Biogen Idec	USA	NA	Health Care	A	Yellow	4	BB	0.24%
Medco Health Solutions	USA	NA	Health Care	A	Yellow	4	B	0.20%
Illinois Tool Works	USA	NA	Industrials	BB	Yellow	4	B	0.19%
Compass Group	UNITED KINGDOM	EU	Consumer Discretionary	A	Yellow	3	BBB	0.16%
Rogers Communications B	CANADA	NA	Telecommunication Services	BBB	Yellow	4	A	0.14%
Ventas	USA	NA	Financials	BB	Green	10	B	0.13%
Unicredit Ord	ITALY	EU	Financials	AA	Yellow	3	BB	0.13%
Svenska Handelsbk A	SWEDEN	EU	Financials	A	Green	10	BB	0.12%
British Sky Broadcasting	UNITED KINGDOM	EU	Consumer Discretionary	A	Green	5	BBB	0.12%
Nomura Holdings	JAPAN	PA	Financials	AA	Yellow	3	BB	0.11%
Telecom Italia Ord (New)	ITALY	EU	Telecommunication Services	BBB	Yellow	4	A	0.10%
Fifth Third Bancorp	USA	NA	Financials	A	Green	7	B	0.10%
Li & Fung	HONG KONG	PA	Consumer Discretionary	A	Green	5	B	0.10%
Randgold Resources	UNITED KINGDOM	EU	Materials	BBB	Green	5	BB	0.10%
Ameriprise Financial	USA	NA	Financials	BBB	Green	5	B	0.10%
Marubeni Corp	JAPAN	PA	Industrials	BBB	Green	5	B	0.09%
Health Care REIT	USA	NA	Financials	B	Green	10	B	0.09%
Dai-ichi Life Insurance	JAPAN	PA	Financials	BBB	Green	8	B	0.09%
Burberry Group	UNITED KINGDOM	EU	Consumer Discretionary	A	Yellow	4	BBB	0.08%
Danske Bank	DENMARK	EU	Financials	A	Green	8	B	0.08%
Yara International	NORWAY	EU	Materials	BB	Green	5	BB	0.08%
Roper Industries	USA	NA	Industrials	BBB	Green	10	B	0.08%
Int'l Power	UNITED KINGDOM	EU	Utilities	BBB	Green	8	B	0.07%
Antofagasta	UNITED KINGDOM	EU	Materials	BBB	Green	5	BBB	0.07%

\* GS (Global Socrates) rating is a bundling of ESG performance and highly controversial business activities represented by Impact Monitor Ratings

# Discussion Points

- Is the application of the following enhancements to the existing MSCI Global ESG Indices Methodology appropriate?
  - ESG ratings used for the Index Reviews would be taken as of the last calendar day of the month preceding the Index Review
  - Only 'BB' and above rated non index constituents eligible for inclusion
  - Use a higher buffer of 'AA' when selecting 50% free float adjusted market capitalization of every sector
- Is the application of a higher Impact Monitor controversy assessment of very severe or severe for non index constituents appropriate?
- What would be the appropriate timeline for the transition?

# Appendix

# IVA Rating System

- IVA ratings represent an assessment of how well companies manage their exposure to environmental, social and governance risks and opportunities.
- The IVA ratings model assigns the majority of the scoring weight to the key ESG issues of an industry.
- IVA ratings are based on a 7 point scale, AAA-CCC. The ratings are based on the scores of the top and the lowest scoring companies in any given industry.
- IVA ratings are designed to complement conventional analysis of company financial performance. IVA ratings highlight how certain key ESG issues might have a material impact on a firm's business model.

# ESG Impact Monitor Overview

- Allows investors to analyze a company's significant social and environmental impacts and its ability to manage those impacts
- Captures ESG controversies and violations involving publicly traded companies
- Based on five categories of ESG Research
  - Environment, Customers, Human Rights & Community, Labor Rights & Supply Chain, Governance
- Three categories: Red (0-1), Yellow (2-4) and Green (5-10).
- Current constituents with an Impact monitor controversy assessment of very severe (IM flag of RED & IM Score: 0&1) will be excluded from the MSCI Global ESG Index. A higher threshold of very severe and severe/structural controversy assessment( IM Flag of YELLOW & IM Score:2) will be applied for exclusion for Non Index constituents
- The distribution by market cap and number of securities in MSCI World is shown below
  - No company in the existing MSCI World ESG Index have an Impact Monitor flag of Red

IM Flag	IM Score	Not in MSCI World ESG	
		Weight	Count
Red	0	8.3%	29
Yellow	2	21.1%	136
Yellow	3	2.9%	56
Yellow	4	5.7%	94
Green	5	7.3%	194
Green	6		
Green	7	0.5%	19
Green	8	2.5%	100
Green	10	3.2%	173
#N/A		0.4%	19
<b>Total</b>		<b>52.0%</b>	<b>820</b>

IM Flag	IM Score	In MSCI World ESG	
		Weight	Count
Red	0	-	-
Yellow	2	13.5%	86
Yellow	3	5.3%	75
Yellow	4	8.8%	95
Green	5	10.9%	237
Green	6	0.1%	1
Green	7	0.9%	15
Green	8	4.2%	120
Green	10	4.2%	164
#N/A		0.1%	2
<b>Total</b>		<b>48.0%</b>	<b>795</b>

\* As of close of November 30 2011

# ESG Impact Monitor

## List of companies with IM Rating as RED

Name	Country Name	Sector	IVA rating	In Current ESG Index	IM Rating
EXXON MOBIL CORP	USA	Energy	BB	0	Red
CHEVRON CORP	USA	Energy	BB	0	Red
NESTLE	SWITZERLAND	Consumer Staples	A	0	Red
PFIZER	USA	Health Care	B	0	Red
BP	UNITED KINGDOM	Energy	BB	0	Red
TOTAL	FRANCE	Energy	BBB	0	Red
WAL-MART STORES	USA	Consumer Staples	BBB	0	Red
RIO TINTO PLC	UNITED KINGDOM	Materials	A	0	Red
BAYER	GERMANY	Health Care	BBB	0	Red
ANGLO AMERICAN (GB)	UNITED KINGDOM	Materials	AA	0	Red
BARRICK GOLD CORP	CANADA	Materials	BBB	0	Red
GOLDMAN SACHS GROUP	USA	Financials	A	0	Red
ABB LTD	SWITZERLAND	Industrials	AA	0	Red
DAIMLER	GERMANY	Consumer Discretionary	CCC	0	Red
MONSANTO CO	USA	Materials	CCC	0	Red
FREEPORT MCMORAN C & G B	USA	Materials	BB	0	Red
HALLIBURTON CO	USA	Energy	CCC	0	Red
NEWS CORP A	USA	Consumer Discretionary	CCC	0	Red
RIO TINTO LTD	AUSTRALIA	Materials	0	0	Red
BAE SYSTEMS	UNITED KINGDOM	Industrials	CCC	0	Red
NEWS CORP B	USA	Consumer Discretionary	CCC	0	Red
TYSON FOODS A	USA	Consumer Staples	CCC	0	Red
ALPHA NAT RESOURCES	USA	Energy	B	0	Red
TOKYO ELECTRIC POWER CO	JAPAN	Utilities	CCC	0	Red
ALCATEL LUCENT	FRANCE	Information Technology	AAA	0	Red
KBR	USA	Industrials	CCC	0	Red
OLYMPUS CORP	JAPAN	Health Care	CCC	0	Red
VEDANTA RESOURCES	UNITED KINGDOM	Materials	CCC	0	Red
FOXCONN INTERNATIONAL	HONG KONG	Information Technology	BB	0	Red

\* As of close of November 30 2011



# Coverage - Transition

	Current Index	Proforma Index
<b>Canada</b>		
Consumer Discretionary	63.57%	63.57%
Consumer Staples	55.66%	54.61%
Energy	51.49%	56.52%
Financials	49.40%	50.30%
Health Care	100.00%	100.00%
Industrials	88.60%	84.86%
Information Technology	100.00%	100.00%
Materials	44.36%	50.73%
Telecommunication Services	66.61%	46.57%
Utilities	60.92%	60.92%
<b>Europe + Middle East</b>		
Consumer Discretionary	53.74%	50.26%
Consumer Staples	42.03%	42.61%
Energy	32.20%	34.40%
Financials	54.38%	57.74%
Health Care	54.10%	58.18%
Industrials	47.88%	50.98%
Information Technology	57.28%	54.05%
Materials	55.15%	53.32%
Telecommunication Services	50.00%	51.68%
Utilities	48.10%	51.32%

	Current Index	Proforma Index
<b>Pacific</b>		
Consumer Discretionary	49.05%	50.17%
Consumer Staples	50.51%	60.26%
Energy	52.52%	54.58%
Financials	49.89%	49.64%
Health Care	49.39%	53.42%
Industrials	51.31%	49.02%
Information Technology	51.15%	51.62%
Materials	50.86%	50.47%
Telecommunication Services	55.11%	55.11%
Utilities	52.72%	57.13%
<b>USA</b>		
Consumer Discretionary	50.08%	49.42%
Consumer Staples	48.87%	48.89%
Energy	27.30%	28.23%
Financials	53.95%	51.42%
Health Care	52.63%	51.96%
Industrials	52.81%	50.29%
Information Technology	49.62%	49.62%
Materials	43.19%	43.85%
Telecommunication Services	24.02%	24.88%
Utilities	41.57%	37.58%

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