FAQ: MSCI CHINA A INTERNATIONAL INDEX – MSCI ESG RATINGS

MSCI ESG Research

June 2018

MSCI ESG Research has initiated ESG Ratings of MSCI China A International Index constituents. This milestone in MSCI ESG Research's coverage expansion is designed to support institutional investors who may have exposure to China's equity market and seek to adhere to their ESG principles. On May 28, 2018 MSCI ESG Research completed ESG Ratings coverage of the MSCI China A International Index constituents (423 securities), which also include MSCI China A Large Cap Inclusion Index constituents (231 securities).

Below is a list of questions most frequently asked by corporate issuers and global investors with regard to the ESG Ratings characteristics of Chinese corporate entities.

How does the MSCI ESG Rating distribution look for the MSCI China A International Index Constituents?

The ESG Ratings distribution of the MSCI China A International Index constituents as of May 28, 2018 skews towards the lower ratings bands. Approximately 29% of the large cap Chinese companies and about 35% of all new additions have a CCC ESG Rating. No company in the index has been rated AAA, as of May 2018.

Figure 1 – MSCI ESG Ratings distribution of selected benchmarks (as of May 29, 2018)

Why does the ESG Rating distribution skew towards lower rating bands?

MSCI ESG Rating uses an industry-neutral approach and identifies best-in-class and worst-in-class companies within an industry peer set. Low rating (e.g. CCC) indicates that a company's ability to mitigate key ESG risks falls short of its global industry peers.

Approximately 34%% of the Chinese companies in the coverage universe belong to Industrials and Materials sectors. Due to the high ESG intensity of these industries, global companies in these industries have faced prolonged and consistent stakeholder and regulatory scrutiny on ESG issues. As a consequence, some have improved strategies to mitigate their ESG risks.

In comparison, China A companies face higher risk exposure on the key ESG issues for these industries, but most have yet to develop comprehensive policies to manage these risks. As part of China's transition to less resource-intensive greener economy, we've found that companies are subject to more aggressive environmental targets and more stringent environmental policies. Chinese companies in the Materials & Industrials Sector face exacerbated transition risks associated with pollutant emissions, natural resource consumption & depletion; and many lags their industry-leading peers on emission reduction efforts, policies and commitments to gain resource efficiency.

China's transformation and strategic shift from industrialized economy to service-based economy also poses challenges across social issues. In particular, shortage of trained and experienced professionals in Financial sector (14% of companies in the coverage universe), Technology (10% of companies in the coverage universe), and Healthcare (9% of the companies in the coverage universe) is one of the core constraints to growth.

Additionally, new China privacy law enacted in 2017 and increased scrutiny of product safety triggered by a wave of past product recalls, set new level of stringency in compliance for Consumer sector (13% of companies in the coverage universe).

Why does MSCI ESG Research compare Chinese entities to global industry peers? Does MSCI take local norms and practices into consideration when it compares Chinese entities to global peers?

MSCI ESG Ratings are used by investors with a global investment footprint. In this context, MSCI ESG ratings are designed to provide a relevant comparison of companies' ESG risk resilience.

The MSCI ESG Rating model, however, incorporates regional norms and practices in the overall rating framework. These aspects are integrated in evaluation of regulatory risk drivers and compliance-based practice norms. In assessing corporate governance structures and practices, MSCI ESG Research takes a dual approach in benchmarking companies both to global peers as well as home market peers that are subject to the same governance codes.

A significant percentage of Chinese companies under MSCI ESG Research coverage have the Chinese State as the controlling shareholder. Does that lead to a lower MSCI Corporate Governance Score?

Controlling ownership by the State does not in itself lead to a lower score under the MSCI Governance methodology. It only becomes an area of concern where the controlling ownership leads to or is combined with other governance risks, such as unequal voting rights, lack of board independence, related party transactions or concerns regarding board leadership, skills and diversity, etc.

MSCI ESG Research takes the same approach for China as for the role of the state in other markets like Brazil, India, Russia and South Africa. The most salient feature of a SOE is its explicit obligation to a much wider group of stakeholders than other listed companies, including customers, employees and to what might best be described as the “public good”. Quality of management, overall board skills and effectiveness, combined with strong internal control and accounting transparency constitute some of the most important corporate governance considerations at SOEs.

What type of ESG Rating review process is applied by MSCI prior to the rating release?

The ESG Ratings process has built in multiple steps to review the quality of the analysis as well as the consistency of the methodology and the ratings signal. This process is applied for all companies rated by MSCI ESG Research, including constituents of the MSCI China A International Index.

Figure 2 – MSCI ESG Rating Process and Reviews

In the course of ratings research for a given company, the following quality assurance processes are in place:

Industry Ratings Review: Ratings and scores for companies in an industry peer group are reviewed by a group of senior analysts – typically the Sector Lead and the Market Lead -- before analysts can finalize the ratings and commence writing company reports. At this point of the process, any ratings movements, the ratings distribution across peer sets are reviewed, and analysts defend their assessment to the senior Sector and Market Leads. Any significant issues are escalated to the ESG Ratings Methodology Committee for further review and resolution.

ESG Ratings Methodology Committee Review (RMC): The RMC is composed of the Head of ESG Ratings Research, Head of ESG Ratings Methodology; and rotating members of the ESG Research team representing the North American, European, and Asia-Pacific teams. On a weekly basis, analysts bring company research to the ESG Rating Methodology Committee Review to review and approve AAA and CCC rated companies, rating changes, company-specific, industry or market model adjustments based on the existing methodology for handling such exceptions (e.g., addition of key issues based on unique business characteristics based on the methodology rules, deviations from the weights for Industry Key Issues due to significant differences in business model from the industry peer set).

ESG Methodology Committee (EMC): This committee considers proposals for methodological changes across the ESG Research Group. All coverage expansion ESG Rating distribution, market-specific methodology, market-specific additional data sources, and ESG rating outliers are reviewed by this committee. Other ESG Ratings research issues that are typically considered at the EMC level include the following:

- Upgrade, downgrade, or requests for truncation of ESG ratings of the highest profile companies
- Event-driven mid-cycle ratings review of the highest profile companies
- Annual proposal of changes to Industry Key ESG Issues or weighting methodology
- Proposed changes to ESG ratings methodology
- Quarterly maintenance reviews

Quality Review Committee (QRC): This committee aims to conduct data quality checks on all companies prior to the ESG Ratings publication that occurs twice every month. The QRC has instituted automated quality checks that flag the Committee whenever pre-specified conditions relating to ratings and score changes are triggered, or in case of any suspect values. The reports that do not meet the quality standards are sent back to analysts for review and correction. Furthermore, the QRC also undertakes quality checks every month to ensure that the published reports are error free. The QRC also engages in identifying and improving metrics aimed at refining the overall quality quotient of the model.

ESG Issuer Communication: Companies are invited to participate in the data review process prior to the annual update of their ESG rating or at any time through-out the rating cycle. Companies are notified about upcoming review of their ESG Rating and are given an opportunity to review and comment on the factual data and estimates contained in the ESG Rating Data Verification report, as well as to provide MSCI's ESG Research team any additional ESG information, as long as the information they share is public. MSCI does not share ratings, scores, and competitors' data with the issuers.

How does MSCI deal with low levels of disclosure around companies' ESG policies and performance metrics?

It should be noted that the MSCI ESG Rating is not entirely or even primarily driven by company disclosure. MSCI relies on many other public data sources, such as government, academic, NGO, and commercial databases, enforcement and media sources, and other specialized data sets to build an objective ratings signal (see Figure 4 for examples of additional data sources reviewed for China A coverage universe). As such, while increased disclosure can help refine the assessment, it does not necessarily translate to a higher rating – voluntary company ESG disclosures can only influence the rating to an extent.

The issue of low levels of voluntary disclosure around ESG practices and performance is indeed highly pronounced in the case of China A companies. We find that only 2% of the companies in the coverage universe produced sustainability reports and offered details on ESG policies, practices, and performance track record (compared to 34% of MSCI ACWI constituents) at the time of the assessment. In the absence of voluntary disclosure, MSCI ESG Research has identified over 40 applicable compliance-based norms and practices that companies across industries are subjected to even if they do not explicitly disclose these mandates (see Figure 3).

Figure 3 – Examples of compliance-driven practices applied in ESG Rating analysis of *Biodiversity and Land Use* practices for relevant MSCI China A International Index constituents

Indicator	Applicable compliance requirement
Scope of policies to minimize environmental impact of operations	Environmental Protection Law Mineral Resources Law of the People's Republic of China
Policy includes commitment to reclaim habitat, disturbed land to pre-disturbed conditions	Regulation for Eco-environmental Protection and Reclamation for Mining
Policy includes commitment not to operate in high conservation areas (i.e. World Heritage sites, nature preserves, etc)	Regulation of the People's Republic of China on Nature Resources Mineral Resources Law of the People's Republic of China
Scope of site-specific action plans to minimize adverse impact on biodiversity and land	Regulation for Eco-environmental Protection and Reclamation for Mining Environmental Protection Law
Scope of programs to restore or rehabilitate disturbed areas	Mineral Resources Law of the People's Republic of China
Company implements measures for pollution prevention and management (e.g., spill containment, sediment minimization, toxin exposure minimization)	Regulation for Eco-environmental Protection and Reclamation for Mining Environmental Protection Law Law of the People's Republic of China on Promoting Clean Production
Company conducts biodiversity impact assessment prior to settling in new areas	Regulation for Eco-environmental Protection and Reclamation for Mining Law of the People's Republic of China on Evaluation of Environmental Effects

Figure 4 – Examples of additional public data sources used in ESG Rating analysis of MSCI China A International Index constituents

Third Party Mandatory sources:

- State Administration of Work Safety - Injury & Fatalities
- National emission license system – EMS system
- Ministry of Industry and Information Technology – Average fleet emissions
- National Defective Product Administrative Center – Product recalls
- China Food and Drug Administration (CFDA) – Product recalls, warning letters

Third Party Voluntary sources:

- Institute of Public and Environmental Affairs (IPE) – Environmental fines
- Zhaopin.com - Best Employer Award
- Green Finance Committee/China SIF – Memberships, signatories to Responsible Investment

From MSCI ESG Research's perspective, what are the main additional disclosure metrics that could help Chinese companies improve their ratings?

We do not advise companies as to how they can improve their ratings. As noted earlier, ESG rating model is constructed to minimize the impact of low levels of voluntary disclosure on the overall rating. That said, while higher level of disclosure is not an imperative for higher rating, it does enable us to provide more granular assessment and comparison to peers.

The ESG Ratings in general measure potential exposure to ESG-related risks based on the business structure and exposure to high-risk markets. In this sense, more granular disclosure of business segment information (revenue and asset data), location of physical assets, and revenues streams by market or country allows for a more precise assessment of a company's risk profile. In addition, greater transparency on scope of programs and policies, measurable improvement targets, and performance metrics related to key ESG issues are useful for our analysts to more precisely measure company-specific risk mitigation efforts and achieved results, and differentiate peers in a comparative analysis. This does not mean that increased transparency or disclosure as described will result in improved scores. The above is what will allow for a more precise assessment only.

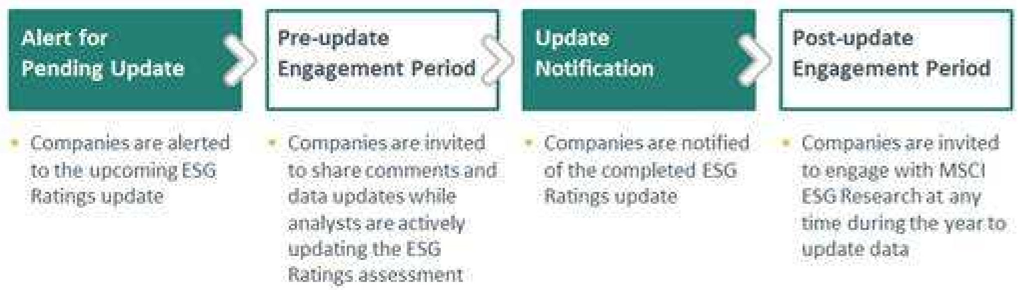
Does MSCI ESG Research use local language sources in its research process?

Local language sources are referenced where relevant. MSCI ESG Research has analysts in almost every major market globally, including China, and leverages on-the-ground language and market expertise as needed as part of our robust research process. However, please note that all of our research reports are produced and available only in English.

How can corporate entities engage MSCI ESG Research on the data verification and feedback process?

MSCI ESG Research has established several data review and verification processes across its core research. Companies are given an opportunity to review and comment on the company-verifiable information that MSCI ESG Research collects. We anchor our standard data verification process in the annual update of the flagship MSCI ESG Rating. MSCI ESG Research only uses publicly available information. We do not conduct general surveys or issue stock questionnaires, and we will not use any confidential information. We do not share draft reports or accept comments on the rating itself. The purpose is to verify factual data related to the company. Companies that have questions about their own MSCI ESG Research reports or our data review process can reach out to a dedicated MSCI ESG Issuer Communications team at esgissuercomm@msci.com.

Figure 5– MSCI ESG Issuer Communication Process



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