Shades of Green: Investor Approaches to ESG

*Featuring: **Rick Redding**, CEO of the Index Industry Association (IIA) and **Veronique Menou**, MSCI's Head of ESG Index EMEA*

Adam Bass (00:03):

This is MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your Host Adam Bass, and today is November 5th, 2020. This week, we pick up on our conversation with Rick Redding, CEO of the Index Industry Association to bring you even more context around the huge rise in ESG Indexes. Also joining us for this discussion, is MSCI's Head of ESG Index in India, Veronique Menou. Vero, thank you so much for joining us.

Vero Menou (00:38):

Thank you for having me.

Adam Bass (00:40):

As you know, we spoke with Rick Redding of the Index Industry Association last week, and one key headline from that talk was.

Rick Redding (00:50):

ESG Index is increased by over 40%, which it's blown away any previous year's record far to see that kind of growth in any category whatsoever.

Adam Bass (01:02):

As someone who lives in the ESG Index world every day. We'd love to hear your reaction to that number.

Vero Menou (01:09):

I can tell you, I've been in the ESG space, actually for more than 16 years now, and ESG has not always been that high on investor's agenda. I'm definitely thrilled to see that the work that we've done educating investors on the relevance of ESG has been very fruitful.

Adam Bass (01:29):

What do you think that is?

Vero Menou (01:30):

ESG is becoming more concrete for investors and also for the general public more broadly. We've seen that with extreme weather events such as, floods, or extreme cold, or extreme heat. Those extreme weather events have been experienced by many. That definitely makes climate change concrete among investors and the general public. COVID as well, and I think COVID was more or is more like a social issue. It is making social issues more prevalent, including inequality, employee wellbeing, job losses, access to healthcare. I think COVID has definitely made social issues within the ESG space a bit more concrete for investor to grasp ESG.

Adam Bass (02:26):

Definitely, all of that makes complete sense, COVID making it more concrete, as you said, and investors just waking up seeing why this is an important area to focus on. That said, some parts of the world are clearly ahead of others. What are you seeing in different parts of the world when you speak with clients?

Vero Menou (02:47):

Indeed. There are regional differences, I'd say that Europe is leading the way while the U.S is still lagging and we see Asia actually catching up. But I'd say that they are also different approaches of ESG investing or different shades of green if you were. You can see light green approach, moderate green approach, and dark green approach. A light green approach means that the primary objective would be to prevent headline risk and align where ethical or political values. You can do that for example, through an exclusion of companies involving controversial activities, such as weapons, tobacco, fossil fuel, alcohol, et cetera. Then you have the moderate green approaches, which integrate ESG as a way to enhance risk adjusted return, through either a selection or best-in-class reproach or a re-rating approach. The last approach or the dark green approach would add an impact component. It's not only about long-term risk and long-term return, it's also about having an impact on society in the environments. That can potentially be achieved through a tilt towards the UN Sustainable Development Goals.

Adam Bass (04:17):

There was another aspect of regional differences that came up when we spoke with Rick. Though, we didn't get to include it in the final episode. That was how different regions have sought to regulate ESG indexes. Let's have a listen.

Rick Redding (04:30):

Historically, there's been a very different way of looking at regulation in Europe, continental Europe I will say, than the way that's been looked at in the United States and Asia, the U.S and Asia primarily looked at regulating products, not necessarily the underlying benchmarks.

Adam Bass (04:48):

European regulation is a subject I know you're very close to, and we'll speak more about that later. But how has ESG regulation evolved?

Vero Menou (04:57):

The number of ESG regulations globally has increased over the past few years and especially in Europe, more recently with the EU Sustainable Finance Action Plan. What's interesting on the regulatory front is not only that regulations have become more numerous, but also that they've changed focus in the sense that they are now more focused on the investors, while they were more focused on issuers of corporates in the past.

Adam Bass (05:26):

Your raising that shift is interesting. One of the issues that Rick mentioned was the potential for some regulations to be drafted in a way that ended up too narrow in scope, or as he put it.

Rick Redding (05:38):

If, for example in climate, if it's the restrictions are too tight and you end up with only making this up as this is a hypothetical, 10 companies that can go in your climate benchmark, the problem with it, that becomes a niche market because no pension plans, risk manager, will let you put $10 billion worth of incremental investing into 10 stocks. If ESG we need to be more inclusionary of finding good companies that across all ESG factors, because the goal of ESG investing is to get these into core portfolios, not make them niche products by having too few stocks and not enough money flow to it.

Adam Bass (06:24):

What have you seen so far, what's been your take?

Vero Menou (06:27):

That's one of the key challenge that we face is how to find the right balance between being too prescriptive and fight against greenwashing.

Adam Bass (06:41):

Greenwashing. Can you give us a quick definition?

Vero Menou (06:44):

Greenwashing is when, for example, you promote a product as being green or ESG, but it doesn't necessarily have very strong or relevant metrics or methodology to justify and demonstrate that this product is ESG and green. As you know, ESG is in its early stages. More data will emerge, more models will develop, more analytical tools will become relevant. It was very important for us while defining, for example, the minimum standouts to allow for flexibility and ensure innovation. But on the other side, not being too stringent and developing rules, that would have been too easy to meet, could have led to us being a choose of greenwashing.

Adam Bass (07:36):

When you say us, you actually served as part of a group pull together the EU Technical Expert Group. This was set up to advise the European Commission about ESG regulation. Can you give us a little bit more detail about this group and the mission that pulled it together?

Vero Menou (07:57):

Sure. The EU Technical Expert Group was a group of 35 experts that have been selected, as you mentioned to help the commission implements part of the Sustainable Finance Action Plan. The group included people from various backgrounds, including academics, civil society investors, as well as corporates. Our mission were to first define the EU Green Taxonomy, develop Green Bond Standard, defining Minimum Standards for Climate Benchmarks, as well as climate disclosure requirements for issuers. This group actually started in July, 2018 and we completed our work in September this year.

Adam Bass (08:46):

What were the recommendations from the group? What was your advice to the European Commission?

Vero Menou (08:51):

So on the benchmark sides, our recommendations were twofold. One, we developed minimum standards for the EU Paris-aligned Benchmark or the EU Climate Transition Benchmark that we call now with the acronym PAB and CTB. That was the first task, the second was around defining ESG disclosure requirement for ESG indices. On the minimum standards for PAB and CTB, what we did is we defined a set of recommendations for index provider to comply with if they wanted to call their indexes PAB or CTB. The minimum standards include requirements, for example, to reduce the carbon footprint of the index compared to its parents, to reduce exposure to Pacific-related activities, to exclude companies that are involved in controversial weapons or violating international norms.

Vero Menou (09:49):

One of the key feature of both the CTB and the PAB is around the self-carbonization. Why? Traditionally when we calculate or when we at the index level, we want to reduce the carbon footprint, we usually do that, comparing it with the parent index. I think what the self-decarbonization is about it's the index itself will decarbonize year on year. What we define as a minimum standards is that the index should decarbonize year on year by 7%. That 7% is actually coming from the IPCC scenario of 1.5 degree.

Adam Bass (10:33):

You also mentioned disclosures. What did that work yield?

Vero Menou (10:36):

We also define a set of guidelines to enhance the transparency of ESG index methodologies, as well as the set of ESG metrics that would have to be disclosed publicly for ESG indices. The idea was to provide more transparency as to the ESG less, if you were of an ESG index. An example of metrics would include the carbon footprint for social exposure, that's on the environmental side. On the social side, that would be indicators such as the gender diversity violation of the UN Global Compact and on the governance side indicators would include for example, independent director at the board.

Adam Bass (11:22):

It sounds like the goal of any regulation around disclosure and measurement, as you say, it's really about investors having the data they need and having faith in that data, so they can make decisions.

Vero Menou (11:35):

When we assess the ESG performance of an issuer, what matters is not what they say they do, but rather what they do from a product or from a portfolio perspective. I think what is also important is first to be transparent on the inputs and the methodology. Explain how a portfolio or an index is constructed. Second also, be transparent on the output. What is it in is index? What makes it ESG?

Adam Bass (12:12):

Well, that's the time we have for right now, Vero, thank you for joining us. We really appreciate your time.

Vero Menou (12:18):

Thank you.

Adam Bass (12:20):

That's all for this week. Our thanks to Rick, Vero and to all of you for joining us. Next week, we talked a little today about the social effects of the pandemic, the S of the ESG. We'll explore that topic more with MSCI Meggin Thwing Eastman. Remember, it takes just a moment to subscribe to the podcast, leave a comment or share with a friend. Remember, it takes just a moment to subscribe to the podcast, leave a comment or share with a friend. Until next week. I'm your Host, Adam Bass and this is MSCI Perspectives. Stay safe.

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