Consultation on Potential Enhancement of the MSCI ESG Enhanced Focus Indexes Methodology

PROPOSAL FOR CONSULTATION

This consultation may or may not lead to the implementation of any or all of the proposed changes in the highlighted or any other MSCI indexes. Consultation feedback will remain confidential. MSCI may publicly disclose feedback if specifically requested by specific market participants. In that case, the relevant feedback would be published together with the final result of the consultation.

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Summary

MSCI presents a consultation on proposals for the potential enhancement of the MSCI ESG Enhanced Focus Indexes methodology

The proposals modify the exclusionary screens and seek to align the index with the minimum requirements for designation as an EU Climate Transition Benchmark (EU CTB).

MSCI invites feedback from market participants on or before August 10 2021, and will announce the results of the consultation on or before August 16 2021. Changes, if any, would be implemented in the November 2021 Semi-Annual Index Review (SAIR).

Background

- The final Delegated Act for the minimum requirements for EU CTBs (EU DA) was published in the Official Journal of the European Union, L 406, 3 December 2020[1].

- MSCI proposes to enhance the MSCI ESG Enhanced Focus Indexes methodology to align the index with the minimum requirements required for designation as an EU CTB.

- The proposed index methodology retains the existing optimization-based approach that seeks to maximize exposure to environmental, social and governance (ESG) factors while maintaining risk and return characteristics similar to those of the corresponding Parent Index while adding additional constraints as required for an EU CTB.

- The proposed index methodology also incorporates additional exclusionary security-level screens related to involvement with conventional weapons and with unconventional oil and gas.

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1. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2020:406:TOC

Information Classification: GENERAL

Proposed Changes* to Current Index Methodology

Proposed changes to Eligibility Criteria:

- *Proposals for new screens* –
    - **Conventional Weapons**: Exclude companies deriving 5% or more revenue from the production of conventional weapons
    - **Conventional Weapons**: Exclude companies deriving 10% or more aggregate revenue from weapons systems, components and support systems and services
    - **Unconventional Oil & Gas**: Exclude companies deriving 5% or more revenues from oil sands, oil shale (kerogen-rich deposits), shale gas, shale oil, coal-seam gas, coal-bed methane as well as Arctic onshore/offshore reserves.
    - **Environmental Controversies**: Exclude companies with an MSCI Environment Controversy Score of 0 or 1 (applicable from the November 2022 SAIR)
- *Proposal to remove screen* –
    - **Oil Sands**: Revenues from Oil Sands are covered in the proposed “Unconventional Oil & Gas Screen” rendering the current screen redundant

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* All other criteria detailed in the methodology of the MSCI ESG Enhanced Focus Indexes methodology will continue to apply in the proposed index methodology

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Proposed Changes* to Current Index Methodology

Proposed changes to Optimizer Setup:

- *Proposals to add optimization constraints*–
    - Minimum **7% annualized reduction** in weighted average carbon emissions (Scope 1+2+3 emissions relative to EVIC) relative to weighted average carbon emissions at the Base Date
    - Minimum 0% **active weight in High Climate Impact Sector** relative to the Parent Index
    - Ratio of **wtd. avg. Green Revenue to wtd. avg. Fossil Fuels-based Revenues** to be at least equivalent to that of the Parent Index
- *Proposals to modify optimization constraints*–
    - Minimum 30% reduction in wtd. avg. carbon emissions (**Scope 1+2+3 emissions/ EVIC**) vs. Parent Index
    - Minimum 30% reduction in wtd. Avg. potential carbon emissions (**per dollar of EVIC**) vs. Parent Index
    - Ex-ante Tracking Error budget at rebalance increased to **75 basis points for developed markets**
    - **Maximum asset bound multiples are increased** to assist feasibility of new constraints
    - In cases of an initial infeasible optimization at rebalance, the **relaxation steps have been amended** to efficiently achieve a feasible index solution.

For further details, kindly refer to Slides 8 and 9.

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* All other criteria detailed in the methodology of the MSCI ESG Enhanced Focus Indexes methodology will continue to apply in the proposed index methodology

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Appendix

Proposed Index Methodology (1/3) – Eligibility Criteria

	Proposed Index Methodology	Current Index Methodology
Eligibility Criteria		
ESG Controversies	As per Section 3.3 of the current index methodology	As per Section 3.3 of the current index methodology
Missing ESG Data	As per Section 3.3 of the current index methodology	As per Section 3.3 of the current index methodology
Controversial Weapons	As per Section 3.3 of the current index methodology	As per Section 3.3 of the current index methodology
Nuclear Weapons	As per Section 3.3 of the current index methodology	As per Section 3.3 of the current index methodology
Civilian Firearms	As per Section 3.3 of the current index methodology	As per Section 3.3 of the current index methodology
Tobacco	As per Section 3.3 of the current index methodology	As per Section 3.3 of the current index methodology
Thermal Coal	As per Section 3.3 of the current index methodology	As per Section 3.3 of the current index methodology
Oil Sands	**This exclusion is no longer applied as revenues from Oil Sands are covered in the "Unconventional Oil & Gas" screen below**	As per Section 3.3 of the current index methodology
Conventional Weapons	**Exclude companies deriving 5% or more revenue from the production of conventional weapons**	No exclusion in the current index methodology
Conventional Weapons	**Exclude companies deriving 10% or more aggregate revenue from weapons systems, components, and support systems and services**	No exclusion in the current index methodology
Unconventional Oil & Gas	**Exclude companies deriving 5% or more revenues oil sands, oil shale (kerogen-rich deposits), shale gas, shale oil, coal seam gas, coal bed methane as well as Arctic onshore/offshore.**	No exclusion in the current index methodology
Environmental Controversies	**Exclude companies with an Environment Controversy Score of 0 or 1 (This screen will be applicable from the November 2022 SAIR)**	No exclusion in the current index methodology

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Proposed Index Methodology (2/3) - Optimization

	Proposed Index Methodology	Current Index Methodology
Optimization Setup		
Optimization Objective	Retained in Proposed Index Methodology	Maximize ESG Score
Ex Ante Tracking Error Budget	Developed Markets – **75bps** (except for Pacific ex Japan with 125bps) Emerging Markets – 100bps	Developed Markets – 50bps Emerging Markets – 100bps
Minimum Constituent Weight	Retained in Proposed Index Methodology	Minimum constituent weight in the Screened Parent*
Asset Lower Bound	Maximum (Minimum constituent weight in the Screened Parent, **0.25** * Security Weight in the Screened Parent)	Maximum (Minimum constituent weight in the Screened Parent, 0.5 * Security Weight in the Screened Parent)
Asset Upper Bound	Minimum (**5** * Security Weight in the Screened Parent, Security Weight in the Screened Parent +2%)	Minimum (3 * Security Weight in the Screened Parent, Security Weight in the Screened Parent +2%)
Minimum Reduction in the Carbon Emission Intensity relative to the Parent Index	30% - **calculated as per Appendix I of the MSCI EU CTB/PAB Overlay Indexes Methodology**	30% - calculated as per Appendix I of the MSCI Global Low Carbon Leaders Index methodology
Minimum average reduction (per annum) in GHG Intensity relative to GHG Intensity of the index at the Base Date (November 2021 SAIR)	**7% - calculated as per Appendix I of the MSCI EU CTB/PAB Overlay Indexes Methodology**	No constraint in the current index methodology
Minimum Reduction in the Potential Emissions relative to the Parent Index	30% - **Potential Emissions are now calculated per dollar of Enterprise Value Including Cash (EVIC)**	30% - calculated as per Appendix I of the MSCI Global Low Carbon Leaders Index methodology
Ratio of Green Revenues to Fossil Fuels-based Revenues	**Ratio of wtd. avg. Green Revenue to wtd. avg. Fossil Fuels-based Revenues to be at least equivalent to that of the Parent Index**	No constraint in the current index methodology
Minimum active weight in High Climate Impact Sector	**0% - for details regarding the definition of the High Climate Impact Sector, kindly refer to the MSCI EU CTB/PAB Overlay Indexes methodology**	No constraint in the current index methodology

* The Screened Parent is constructed by excluding securities from the Parent Index using the Eligibility Criteria detailed in the index methodology. The security weights are then renormalized to 100%. Apart from the changes in the Eligibility Criteria, there is no change in the way security weights are calculated in the Screened Parent.

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Proposed Index Methodology (2/2)

	Proposed Index Methodology	Current Index Methodology
Optimization Setup (contd.)		
Active Sector Weights	Retained in Proposed Index Methodology	+/-5%
Active Country Weights*	Retained in Proposed Index Methodology	+/-5%
One Way Turnover during May and November Index Review	Retained in Proposed Index Methodology	10%
One Way Turnover during Feb and Aug Index Review	Retained in Proposed Index Methodology	5%
Specific Risk Aversion	Retained in Proposed Index Methodology	0.075
Common Factor Risk Aversion	Retained in Proposed Index Methodology	0.0075
Infeasible Solution		
Relaxation Steps followed	• **The turnover constraint will be relaxed up to a maximum of 5 times of the original turnover budget in steps of 5%** • **The ex-ante tracking error is relaxed up to a maximum of 5 times of the original ex-ante tracking error in steps on 0.1%.** **The relaxations are completed in an alternative manner – a single step of turnover relaxation is followed by a single step of ex ante tracking error relaxation, before the turnover constraint is relaxed further.**	• The turnover constraint will be relaxed up to a maximum turnover of 30% in steps of 1% • The ex-ante tracking error is relaxed up to a maximum of 5 times of the original ex-ante tracking error in steps on 0.1%. The turnover relaxation is completed up to a maximum of 30% before the ex-ante tracking error constraint is relaxed.

* In case there are countries in the Parent Index which weigh less than 2.5% in the Parent Index, then for such countries the active country upper bound of +5% is not applicable. When a country weighs less than 2.5% in the Parent Index then the upper bound of country weight in the MSCI ESG Enhanced Focus Index is set at three times of the country's weight in the Parent Index.

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