MSCI ESG THOUGHT LEADERS COUNCIL

FROM MSCI ESG RESEARCH LLC

CORPORATE GOVERNANCE AND FIXED INCOME ISSUERS

INTRODUCTION

GENERAL

The MSCI ESG Research Thought Leaders Councils are convened to provide a forum for specialists to discuss topical and challenging ESG issues confronting investors. The private forum typically consists of 4-7 participants. These discussions serve as an opportunity for the invited experts and MSCI ESG Research to have an open and frank exchange of ideas. Results of the discussion are summarized and posted on MSCI's website.

CORPORATE GOVERNANCE AND FIXED INCOME ISSUERS

What corporate governance best practices do investors in fixed income securities look for? Fixed income investors have different priorities and expectations as compared with equities investors - could these result in conflicts of interest in terms of governance expectations? Are there areas of common ground which all investors agree are important for good governance? Discussion questions for the MSCI ESG Research Thought Leaders Council participants covered many of these issues.

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KEY TAKEWAYS

GOVERNANCE PRIORITIES: FIXED INCOME VS. EQUITIES

Discussion focused on how the definition of good governance for bondholders vs. shareholders can vary across a number of specific governance metrics.

Some council members posited that **different rights** held by bondholders vs. shareholders explain most of the differences. Others noted that and that the **risk appetite** of bondholders differed from that of shareholders. In general, council members agreed that bondholders are more **focused on risk mitigation**, looking for evidence of a history of being well governed as a determinant of an issuer's ability to meet its bond obligations. By comparison, shareholders are risk takers and more willing to target short-term gains (increased dividends, share buybacks, re-structuring and M&A activity) over long-term strategies.

Discussion of short- vs. long-term time horizons prompted some disagreement among council members. While one council member predicted a gradual shift from total return strategies to liability driven investments as rates normalize, others argued that bondholders are inherently shorter term in practice (it's "as much about trading as about investing") even if they may be longer term in theory.

OWNERSHIP

Most council members agreed that an understanding of the governance risks arising from the ownership structure is critical for bondholders, as it is for shareholders, emphasizing the importance of transparency on the equity ownership structure. For listed companies, a review of the shareholder list to establish whether controlling or family owners dominate, or for widely held firms whether index funds dominated, could signal the likely priorities for capital allocation and distribution policies.

However, different ownership structures may have different implications for bondholders vs. shareholders. For example, council members indicated that creditors often prefer companies with a controlling or family shareholder, as they are typically more stable and resistant to short term expedient opportunities.

The issues of shareholder rights and takeover defenses were also deemed important for bondholders, as they tend to prefer measures that limit the risk of activist shareholders, LBOs, or other changes of control. The rise in shareholder activism came up from multiple participants as a risk of high interest to bondholders, as activists can pressure selling of assets at inopportune times and are typically regarded as credit negative.

THE ROLE OF THE BOARD

For bondholders, the Board quality was equally as important as it was to equity investors. Participants opined that the board should be structured to reflect the ownership structure. Unexpected departures for senior roles (CEO, CFO in particular) are a big governance red flag.

CAPITAL ALLOCATION & DISTRIBUTION POLICIES

Capital allocation and distribution policy is another area of potential disagreement between bondholders and shareholders. Bondholders tend to favor a re-investment strategy to strengthen a company's ongoing ability to repay creditors, whereas a shareholder may be interested in maximizing short-term share value through dividends, buybacks or even more aggressive options. Clear signaling of dividend policy and transparency around a company's long-term capital allocation and funding strategy were important for some council members, with any deviations from the stated policy requiring close attention.

CORPORATE INTEGRITY & ACCOUNTING

One takeaway was that governance for bondholders often comes down to a question of trust: "can we trust this company to pay us back," as opposed to a question of minority shareholder protection and agency risk. There was clear consensus of the need to broaden the assessment of governance to cover areas that speak to this question of trust. For example, the history of any defaults and the reason for these were deemed as crucial to understanding credit risk. Similarly, council members placed a high priority on understanding the quality of accounting and financial reporting.

Some council members broadened the scope of governance even further, by requesting more data and analysis on the preparedness of companies to future regulations, contingent liabilities, and the governance of environmental and social risk management.

EXECUTIVE PAY

Council members noted that well-managed executive pay structures were one indicator for good governance, and thus a positive indicator for bondholders. Some focused on whether the executive pay incentive structure **incentivized** risky behavior. Others noted that because they could not vote on executive pay they paid it less attention than other matters.

STEWARDSHIP & ENGAGEMENT FOR BOND HOLDERS

Most council members agreed that engagement was an important method of emphasizing bondholder interests and determining how well a board/management was managing its environment and social risks. Some council participants noted that although engagement was important it was often difficult to gain access to members of the board and/or management team other than the CFO or treasurer –without the formal mechanisms provided through voting rights. Others noted the importance of joining collaborative efforts with shareholders on key E, S and G issues when their interests were aligned.

OTHER CHALLENGES

As debt instruments are often issued by a distinct legal entity like a subsidiary or SPV, participants indicated that a critical part of any governance assessment is determining where the governance risk is located. Council members posited that the governance risk assessment is most appropriate for whichever company has its own governance structure (a functioning board of directors) and is in control of its own destiny, which in some cases may be the parent or ultimate parent company and not the issuer itself.

The question of disclosure was raised, particularly in the case of private companies that do not make their financial statements or governance structures publicly available. For issuers where disclosure was lacking, council members agreed that it might be preferable to not provide a rating unless a minimum disclosure threshold had been met.

Council members also discussed whether governance assessments should be bond-specific rather than residing at the issuer level. While some raised that analysis of bond covenants could be useful in the context of governance, others suggested that ESG rating agencies continue to focus on benchmarking issuers against a relevant peer group, leaving security-level nuance to the analyst or portfolio manager.

GOOD GOVERNANCE STANDARDS: ASSET-CLASS AGNOSTIC V. ASSET-CLASS SPECIFIC

In conclusion, most council members agreed that taking a long-term investment horizon, the interests of equity and debt holders are well aligned. In critical areas such as board structure and board effectiveness, executive pay, corporate integrity, and accounting quality, the larger questions asked by bondholders and shareholders are more or less the same. Council members were also supportive of approaches that broaden the scope of analysis beyond governance best practices to include insight into capital management, succession risk, and other areas of strategic importance.

Divergence of interests between bondholders and shareholders in such areas as ownership and control, and different emphasis on specific governance metrics, may warrant a separate assessment of governance risk for bondholders. Some suggested that the governance rating profile could provide specific commentary in cases where if the outcomes for equity and bondholders might differ.

To conclude, the council discussed the concept of the “Universal Investor” – positing that rather than focusing on diverging interests, the “enlightened creditor” and “enlightened shareholder” should recognize each other and provide a necessary counterbalance to promote long-term thinking in financial markets.

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