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MSCI Announces Changes to Its ESG Rating Methodology, Resulting in Downgrades for Most Funds

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MSCI has announced significant changes to its ESG investment fund ratings methodology that “aim to raise the requirements for a fund to be assessed as ‘AA’ or ‘AAA’ rated, improve stability in Fund ESG Ratings and add transparency through simpler attribution analysis.” However, these changes will result in downgrades to 31,000 of the funds currently rated by MSCI. MSCI also announced new coverage for 8,200 fixed income funds and a “new approach in rating funds with swap-based strategies” that “will rate swap-based ETFs based on the holdings of the replicated index instead of the fund’s collateral holdings.” According to MSCI, the methodology changes are based on client feedback, not regulatory developments in the EU or elsewhere.

MSCI’s main methodological change is now to derive the ESG Quality Score that underlies MSCI ESG Fund Ratings “from a simple weighted average of the ESG scores of the underlying holdings. [MSCI] will no longer apply adjustment factors.” That is because, according to MSCI, the adjustment factors by and large resulted in ratings upgrades because of how those factors were calculated. In particular, at the fund level, the adjustment factor rewards funds for holding companies that are both highly rated and improving their ESG rating. But companies across nearly every sector, “operating under a new environment of increased ESG scrutiny, have been improving and disclosing more of their E, S and G practices.” As a result, “many funds, including broad-market benchmark-replicating funds, are now highly rated by MSCI, in part driven by the momentum adjustment.” MSCI reports that as of December 2022, “approximately 73% of funds in [its] coverage universe (including ETFs, mutual funds and index funds) had a positive adjustment factor, meaning that these funds had greater exposure to companies with improving ESG Ratings than worsening ESG Ratings.” Accordingly, “the goal posts are shifting” in a “new era where improvement in ESG is the status quo,” such that “the threshold required to receive a top ‘AA’ or ‘AAA’ rating should be more rigorous and ambitious.” However, because the adjustment factor “had a mostly upward influence on funds’ ESG Ratings, removing it will lead to more downgrades than upgrades.” MSCI observes that this reflects “a one-time calibration of the entire universe of funds” and is “not indicative of more downgrades to come.”

Taking the Temperature: As we have reported, ESG ratings providers are being subject to scrutiny and potential regulation as a result of concerns regarding the transparency of their methodologies and the lack of consistency in ratings for the same company by different providers. The UK’s Financial Conduct Authority is in the midst of a public consultation on a potential ESG ratings regulatory regime, which closes on June 30. The consultation states that “Treasury considers there is clear benefit to be gained from improving the transparency of methodologies, governance, and processes of ESG ratings providers. These outcomes could be brought about through regulation.” The European Securities and Markets Authority’s (ESMA) Securities and Markets Stakeholder Group (SMSG) earlier this year observed that, with respect to ratings providers, the “methodological choices are presently not always sufficiently disclosed,” and “investors may not be in a position where they can make truly informed decisions, making it necessary for them to compare several ESG ratings and conduct their own research in parallel, often using raw ESG data.” As SMSG observed, the market would benefit from improved “availability, integrity, and transparency of ESG ratings.” The Securities and Exchange Board of India recently sought input into potential ESG ratings regulation, a call for regulation echoed by the International Organization of Securities Commissions.

Despite increased interest from regulators, the ESG ratings industry remains largely unregulated and we expect company ratings and the underlying methodology producing those ratings to remain controversial. We recently reported on the results of the Dow Jones Sustainability Indices Annual Review, which resulted in certain additions to and deletions from the Sustainability Index that provoked comment. We anticipate that calls for regulation will continue while ratings methodologies remain unclear, the sources of information supporting scores varies, and scores diverge among different providers.