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TRANSCRIPT

ESG Now Podcast

"Was SVB all about that ESG?"

Transcript, 31 March, 2022

Bentley Kaplan

Hello and welcome!!! to the weekly edition of ESG Now, the show
that explores how the environment, our society and corporate governance affects, and are affected by our economy. I'm your host for this episode, Bentley Kaplan.

On today's show, we are going to talk about the failure of Silicon Valley Bank. As we are recording this, details are still emerging, pieces are still moving and there is an ongoing Senate committee hearing. And as we wait to see where things are headed for the bank, we are going to take a look at how things got to where they are, and more specifically, how ESG does, or DOESN'T fit into this story. Thanks for sticking around, let's do this.

In early March, on the back of rising interest rates, Silicon Valley Bank, a bank used by many US tech startups, announced that it needed to raise more than 2 billion dollars to shore up its balance sheet. From there, things moved pretty quickly. By the 10th of March, the California Department of Financial Protection and Innovation seized SVB and placed it under the receivership of the Federal Deposit Insurance Corporation or FDIC.

And on the 26th of March, the FDIC, officially took over control of the bank, and administrators are now looking to unwind the bank's investment management, investment bank and wealth management divisions. It's an abrupt and chaotic end to the bank's 40-year history. And as SVB's stakeholders run their post-mortems, a lot are looking at the warning signs that popped up and how much of this was foreshadowed. Or conversely, about signals that said the opposite, that the bank was in good shape, only for it to fail days or weeks later…

And this episode is going to talk directly to these post-mortems. We're going to draw a clear between financially relevant ESG factors, and financially relevant *financial* factors. And in the process, we'll highlight what an ESG rating is, and what it's not. At the time of its collapse, MSCI ESG Research – that's us – had rated SVB Financial Group – Silicon Valley Bank's Parent company at a letter rating of "A". And that's on a scale that goes from the highest of AAA to the lowest of CCC. 7 possible letter ratings, and an "A" put SVB just above average.

And the factors that drove that A-rating included above-average performance on consumer financial protection, average performance on privacy and data security and a range of market-leading corporate governance practices. But, we had also flagged the company for governance risks, including, since 2016, a lack of board-level risk management expertise and a lack of industry expertise on the audit committee since 2021.

So in the context of ongoing debate about the role of ESG data and ESG ratings in investment decisions, we're going to square the circle between an ESG letter rating of A and a company like SVB collapsing. To do that, I've pulled Harlan Tufford into the hot seat. Harlan is based in MSCI's Toronto

office and is one of our team's Corporate Governance experts. And first up, I asked Harlan, at a high level, what our ESG rating is looking to measure, or how to interpret a letter-rating of A.

Harlan Tufford

When we're talking about an A rating, let's take a step back and talk about what an ESG rating – what it is and what we're trying to measure. ESG Ratings look into how companies are managing their environmental, social and governance-related risks and opportunities. And that is a difficult thing to measure, particularly when you compare it with something like a credit rating. Credit Ratings are unidimensional measures. They're looking one thing. They're looking to answer the question of how likely a company is to default on its loans, or not be able to pay back its debt. With an ESG rating, there's a range of different factors and considerations, it's a multidimensional signal.

Bentley Kaplan

Right, so to echo Harlan, an ESG Rating and a credit rating are not the same things. An ESG Rating is NOT a narrow assessment of how likely a given company is to fail.

In our ESG Ratings model, as Harlan points out, we look at several different Key Issues – for a given company, that would be a small number of environmental, social and governance factors that we consider to be financially relevant for that company, based on the industry its operating in. We essentially look at how exposed a company is to these ESG risks and how well it's managing those risks.

For SVB Financial Group, in our ESG rating assessment we looked at one environmental key issue, 4 social key issues, and a two governance themes. And based on the collective assessment of these issues, SVB was doing above average, compared with other banks that we assessed.

Now, environmental and social key issues drove 67% of SVB's rating . An assessment of how well the company was managing risks and opportunities related to its customers, as well as underbanked or underfinanced communities. And also, how the company's investments and policies took into account environmental impacts, including in activities that exacerbate climate change. But I said earlier on and as Harlan stressed several times during our uncut interview, SVB's failure was not tied to either its social or environmental risks.

Most questions are pointing towards the company's decision-making, something that may have to do with SVB's governance. And 33% of our ESG Rating of SVB was based on a governance assessment.

So next, Harlan took me through what a corporate governance assessment looks to measure, how we assessed SVB, and whether this brought up any clues about why it may have failed.

Harlan Tufford

Really, what we're looking at there is to assess the effectiveness of the board's decision-making systems, looking specifically from the perspective of a non-controlling investor. And so we're looking at things like, the board's structure, it's independence, the expertise of its directors, how a company's owned, how it's controlled, investor rights, the degree to which pay is aligned with investor interests, the external auditor, and any kind of significant events that could adversely affect the company's

ability to exercise board-level oversight or that could indicate a weakness in its decision-making process.

And at SVB, overall, the company demonstrated evidence of fairly strong governance practices. It didn't have a perfect board, we'd noticed since 2016 that the board lacked risk management expertise and that is a relevant consideration, given the context. And we'd also flagged the board for lack of industry expertise on its audit committee.

But overall, the company had a majority-independent board, and independent chair, which, particularly in the United States is not a common practice. Fully independent board committees, recent board refreshment, fairly well-aligned executive pay practices and there were no control-enhancing mechanisms like dual-class share structures, so across all of these measures, the company actually came out fairly well across our corporate governance methodology

Bentley Kaplan

OK, so as Harlan explains, SVB's governance structures – data that it must disclose in public filings – looked to be in pretty good shape. A lot of things were in place to support the interests of non-controlling investors.

But, crucially, it wasn't perfect. Some aspects raised specific risk flags. In particular, a board where directors did not appear to have formal risk expertise, and an audit committee that did not have a director from the banking industry. And knowing how the story ended, these risk flags will certainly draw the attention of anyone conducting a post-mortem of SVB's collapse.

There is also a side-story here about an 8-month gap in 2022 when the company did not have a Chief Risk Officer – a highly specialized role specific to just a few industries, including banking. But discussing the nuts and bolts of that headline would be an episode in itself.

So instead, I focused Harlan on another question. Because we have a company that was flagged for risks on its audit committee and on the board itself. Weaknesses that look very conspicuous after the fact. But on aggregate, SVB looked like it had decent corporate governance structures. So how do analysts, or investors think about this – and are there factors that they might consider beyond a model – about what goes on inside an actual boardroom?

Harlan Tufford

So, when we're looking at governance, I think it's important to remember that, first of all that even good systems that appear strong on paper can produce bad outcomes, if the people operating within that system aren't the right people for the job. Decision-makers in corporations are constantly exercising judgement and making decisions based on that judgement and people don't always make the right decisions, and some err more than others.

And for us as rating analysts, this is quite an important consideration because we're really looking at these companies from a thousand-foot view. Our insights into these decision-makers and the systems in which they operate are the disclosure we receive from proxy circulars, annual reports, other disclosures and these sources are very good at telling us quantifiable things that are relatively factual, relatively falsifiable. Like, have any of the directors worked for the company before? Have they otherwise disclosed attributes that could compromise their ability to be independent in thought and

fact at this company? Have they disclosed professional or academic experience that suggests they have risk-management expertise? How does the CEO's pay structure work?

Things like that, we can see from the disclosures, but those disclosures are quite bad at telling us things that companies would never disclose in a proxy circular. Like, which directors ask good questions and which ones are phoning it in in a meeting. Or how well-structured are the board's meeting materials? Are the directors actually looking through the binder they get before each quarterly meeting? Are they actually getting the information they need up-front or is the really important information buried under a thousand pages of schedule A through Z? Are the directors actually independent in thought? And when we move beyond the board level, where we get the most disclosures, down to executives, this gets even trickier, because the further you get from the board and the CEO role, the less information you tend to receive about these decision-makers.

Bentley Kaplan

Right, so this is a key part to the story. It can be difficult or impossible to actually peel back the skin on some of these governance questions. We can make a pretty granular assessment of the frameworks and structures that a company's board uses to make decisions, but knowing exactly how decisions are made is a different question entirely. Companies aren't reporting on how much debate is going on, how many different opinions are being offered, and what information is actually being put in front of directors, and how it's being presented.

And all of that has a bearing on what decisions a company takes, and what strategy is ultimately adopted.

And the outcomes of these decisions and strategies CAN be measured. Sometimes it's about things like a company's emission reduction targets, or its policy on data security, or wage negotiation. Or sometimes it's about how much leverage is acceptable, how to direct new investments.

But whether ALL of these things should be measured in an ESG rating was my last question to Harlan.

Harlan Tufford

The clue really is in the name, I think. We're looking for environmental, social and governance risks and opportunities. And really at SVB, it is quite clear that this was driven by financial decision-makings.

And we did explore, a number of years ago, and asked clients about, bringing in issues related to capital adequacy, or asset quality, liquidity, for example. And the feedback that we received was that this was not the role that ESG Ratings should play in the marketplace.

For example, our corporate governance model evaluates the decision-making framework, but the actual decisions produced by that framework – how much risk to take, how to structure assets and liabilities – these are decisions for investors to evaluate. And I think SVB really demonstrates that distinction – it reinforces that ESG investing strategies are complementary to and not a substitute for an analysis of a company's fundamental financial and business decisions.

Bentley Kaplan

Right, for me, Harlan says it best. It's all in the name. E, S, G does not cover core financial risks. We're looking to assess financially-relevant environmental, social and governance factors, not financially-relevant financial factors.

Harlan also referred to our annual ESG ratings client consultation. Through this process, we propose changes to our ESG ratings model, and that's to help adapt the model as more data becomes available, and as regulations and disclosure requirements change. And we put these proposals in front of clients for their feedback and perspective. When it came to the question of incorporating financial metrics into ESG assessments a few years back, it was a pretty consistent "no thank you". You folks stick to the ESG, and we'll look at financial risks.

Which is how things currently stand. Just like a traditional assessment of financial risk isn't expected to tell you much about how well a bank is managing its risks related to data privacy or financed emissions, an ESG rating isn't designed to tell you about that bank's financial health.

For investors, wanting to know what they can take away from all of this, it might feel like a bit of a difficult ending. But there are a few things worth keeping in mind. To misquote Nick Cave "The death of a company is not the end". ESG is constantly iterating, as more data become available and as we understand more about how incidents like SVB unfold, which means that Ratings models can be better informed. Also, regulators are very engaged in this event, and regulators are ultimately the ones that decide what information companies need to report on. And these requirements also change with time.

So investors might take comfort in both of these ideas. But ultimately, however good an ESG model becomes, and however extensive company disclosures become, it will still be up to them to figure out how to interpret these signals and data. And that also means being able to consider something like governance risks in an ESG model, say a shortage of risk management expertise and more traditional financial considerations, like a company's asset-liability matching strategy. And in knowing how and when to adjust these dials.

And that is it for this week! It's been great to talk to Harlan about his take on the news with an ESG twist.

There is of course a LOT going on in the banking industry at the moment, and if you want to get more of a taste, please go and check out MSCI's Perspectives podcast, hosted by my silky-voiced colleague, Adam Bass. Last week, Adam spoke with Andy Sparks, Jim Costello and Florian Sommer on the episode titled "Banks Have Investors Feeling Déjà vu All Over Again". The show is up on all major platforms, and on MSCI's website.

It's been great to have hosted THIS show for the last few weeks. If you enjoyed it, then drop us some stars on your platform of choice to show us some love.

In the meantime, the host with most, Mike Disabato will be back with a vengeance starting from next week, so hopefully that news will help you get through the rest of your week!

Until then, take care of yourselves and those close to you.

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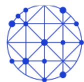

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