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A brief investigation on the growing importance of ESG in business and research

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Introduction

Environmental, social and governance (ESG) related considerations in business have been talked about and promoted by various entities, public and private, since around the middle of the 20th century. However, the topic failed to garner the kind of importance that it deserved. The discovery of the annual depletion of ozone above the Antarctic, first announced by Joe Farman, Brian Gardiner and Jonathan Shanklin, in a paper which appeared in Nature on May 16, 1985, was perhaps the first proven argument that industrialization and human activities did adversely impact our climate irrefutable. Still, it took around another decade for global and political business leaders from 192 countries to get together in Rio de Janeiro and pledge commitment to reducing greenhouse gases. This came to be known as the "Kyoto Protocol". This led to the gradual evolution of the ESG framework which allows any organization to measure and analyze how sustainably it is operating. In 2005, in an UN monitored initiative, large investment companies from 12 countries in the developed world got together to develop the "Principles of Responsible Investment (PRI)" to help put the ESG framework into practice. As on date, PRI has 7000 corporate signatories in 135 countries. HDFC Life Insurance, ICICI Prudential AMC, Axis AMC, ICICI Prudential Life Insurance, among others are some of the institutions from India that have become PRI signatories.

The present and future relevance of the ESG framework in business is huge (Edmans & Kacperczyk, 2022). Of late, our planet has seen unprecedented weather fluctuations, floods, forest fires and other disasters where mankind had a large role to play. In India, the idea of sustainable development is still at a nascent stage. ESG is roughly equated with CSR when in fact CSR is just a component of ESG. There is also a lack of awareness among investors at large regarding green investments and the return potential of such investments.

A short review of literature

The number of natural disasters plaguing the world has been increasing disproportionately to what is an outcome of natural climate change. A quick check on the website "ourworldindata.org" is enough to corroborate this claim. A major contribution to the anomaly is the rapid industrialization and the pursuit of development. Hence, the focus on sustainable development is gaining more and more importance.

According to Edmans & Kacperczyk (2022) the integration of ESG issues into financial decisions is becoming an increasingly important topic. The authors in their work cite three reasons for the rapid rise in sustainable finance. The first reason is its financial relevance. The second reason is its contribution to nonfinancial objectives, and the third reason is an increase in investor preference for sustainable projects. The third reason has also been a focal point in the online article by Larry Fink (2022) titled "The Power of Capitalism" published online at the website "blackrock.com".

Hou Tony Chieh-Tse (2018) in his work titled "The relationship between corporate social responsibility and sustainable financial performance: firm-level evidence from Taiwan" examined the relationship between corporate social responsibility (CSR) and corporate financial performance (CFP) in Taiwan. He found a positive relationship between CSR and CFP.

Tien et al (2020) in their article has investigated the CSR and CES issues and their relationship with CFP in multiple periods of the quickly transforming business landscape of Vietnam economy. This article has contributed a research framework for investigating the issues of CSR and CES related to the CFP, including background theory (stakeholder theory and agency theory), literature reviews (overview of previous studies conducted on the CSR–CES and CFP relation), and methodology (both quantitative and qualitative). The research results may be useful for state agencies and policy makers, management researchers, and business practitioners so that they can introduce research results into practice and conduct similar research in the future. Additionally, the article delves deeply into the two interrelated concepts, CSR and CES, which are the main pillars of very popular today overall and overarching concept of corporate sustainable development.

Gibson Brandon et al (2022) analyzed how responsible investment principles map into ESG portfolio outcomes by studying the PRI, the largest (and UN-supported) global network focused on responsible investment. They compared what institutional investors report doing in terms of ESG incorporation with their portfolio ESG scores to answer which responsible investors in fact invest responsibly. In doing so, they have put forward several research questions including one on the lines of this concept note.

Zerbib (2022) in his work has proposed an asset pricing model using evidence of environmental integration into business profitability and excluding "Sin Stocks". The author has identified the stocks of those companies without ESG commitment as sin stocks.

Discussion

According to the Worldwide Fund for Nature (WWF), in the Indian context, sustainability in the financial sector has evolved little beyond corporate social responsibility. Much work is needed to convince banks that sustainability can offer improved risk management, stronger revenues, reduced cost and brand enhancement. WWF-India's approach to the financial sector follows two main tracks: engagement with individual banks to promote more sustainable business practices; and influencing industry-wide change through improved regulatory frameworks.

Around May 2021, the total Asset Under Management (AUM) of ESG mutual funds was more than Rupees 10,000 crore. This is less than 1 percent of the total AUM of mutual funds in India. With national policies and goals directed towards transitioning India into a developed country with a $ 5 trillion economy by 2024 coupled with greater awareness about the importance of ESG implementation by businesses, and the benefits of green portfolios, AUM of ESG funds is bound to increase.

A single ESG framework cannot suit every country. Hence, the ESG regulations which are optimal for one country need not be very effective for another. This has contributed to a growing interest in studying the impact of ESG related market regulations on business profitability which are country and industry specific.

Conclusion

Once ancillary, ESG considerations are fast becoming fundamental to the core businesses of corporations. This has also resulted in an increased focus on the subject in academic circles. A "Financial Times" top 50 journal, Review of Finance, launched a special issue on "Sustainable Finance" in 2021 and received 176 submissions between June and December 2021 (Edmans & Kacperczyk, 2022). This increased interest in the area is far from being a bubble, especially given the ravages of climate change and social inequities we see around us all the time.

Academic research has also seen an increase in the number of studies which investigate how the implementation of sustainable development projects and initiatives impact organizational bottom lines. Many studies thus far have reported that ESG activities have a positive impact on a business's financial sustainability. However, there are several studies with the contrarian view that ESG implementations result in cost escalations impacting company bottom lines.

This investigation, albeit a very brief one hopes to contribute effectively in increasing awareness among investors at large regarding responsible / green investments and thereby make a miniscule contribution to the country's aspirations in becoming a developed, and sustainable $5 trillion economy.

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