

ESG Investing: Development, Impact, and Challenges

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Abstract

In recent years, ESG (Environmental, Social, and Governance) investing has witnessed notable growth as environmental concerns escalate and public awareness of sustainability rises. As a critical mechanism for improving environmental governance, enhancing financial market transparency, and redirecting capital toward sustainable development goals, ESG also faces some key challenges, including definitional ambiguity, inconsistent reporting standards, and the risk of ESG-washing, which may undermine its credibility. By reviewing ESG literature, the paper suggested that to advance ESG investing, coordinated efforts among stakeholders and the development of robust regulatory frameworks are essential to improve data quality and ensure meaningful evaluations.

Keywords

ESG Investing; Responsible Investing; ESG Risks.

1. Introduction

In recent years, with the deterioration of environmental problems and increasing public awareness about environmental protection, ESG investing has gained unprecedented popularity. According to the Global Sustainable Investment Alliance (2023), sustainable investment assets worldwide have surged to over USD 41 trillion, accounting for nearly 36% of total professionally managed assets [1]. The rapidly expanding scale of ESG investment globally not only reflects the change of investors' concepts, but also marks the transition of the capital market from purely pursuing short-term profits to focusing on long-term sustainable value creation and social responsibility. The surge is leading more and more investors to consider non-financial factors in financial analysis, which contributes to fully evaluating and understanding responsible and ethical business practices. ESG (Environment, Social, and Governance) investing not only provides insight to gauge social responsibilities, and operational sustainability for a business but also is essential to promote sustainable development and solve global problems. However, some challenges may hinder its promotion. To advance ESG investing, it is necessary to bring together efforts among businesses, investors, governments, and other stakeholders to establish a robust framework to define and measure it. In this essay, a definition based on the development history of ESG investing will be presented. Then, it will evaluate potential opportunities and challenges after discussing its significance.

2. The Evolution of ESG

ESG investing can be defined as a novel investing concept that contributes to the environmental, social, and governance with the expectation of receiving a considerable return from the perspective of long-term development. Doumpos, et al. (2023) state that, since the early 19th century, with a series of movements and the emergence of religious thought, responsible investing gained traction and gradually entered the public eye. The development of SRI

(Socially Responsible Investment), which is an evolving concept of socially responsible investing that focuses on non-financial factors, laid a solid foundation for ESG investing and ESG is making it become more than simply a marketing buzzword [2].

The prevalence of ESG investing may be attributed to environmental problems and social development. On the one hand, it is generally believed that human activities have intensified global warming, which appears to incur a series of potential threats. In terms of business and manufacturing, exasperate climate change not only is likely to add uncertainty and disruption to the production chain but also increase the cost of enterprise relocation or maintenance. It is noteworthy that climate change would bring a vulnerability to the ecosystem and cause frequent meteorological disasters to a large extent, which may affect the survival of mankind and species extinction [3]. On the other hand, under the pressure of climate change, awareness of social responsibility and environmental protection has been generally enhanced. Therefore, the number of investors and businesses who are concerned about global issues and ethical business practices is rising. Ethical business practices are widely noticed and involved in rating for investing decisions. Meanwhile, the Millennial generation and Generation Z are likely to drive ESG investing trends. According to Ruggie & Middleton (2019), millennial investors are twice as likely as other investors to invest in businesses that use ESG principles, and 76% of them believe that business could advance social benefits [4].

3. The Significance of ESG

As ESG investing makes significant contributions to environment protection and financial market development, it has become increasingly prominent. ESG investing could provide a deep insight into environmental governance. According to Hill (2020), many major asset managers are emphasizing ESG investing strategies that are aligned with the United Nations Principles for Responsible Investment and Sustainable Development Goals [5]. It might indicate that sustainable development has become a global consensus. ESG investing perhaps is a positive response to environmental challenges, accelerating the green transformation of the economy by directing capital flows to companies with sustainable development potential. Oliver Yébenes (2024) highlights that the business utilizing technology advancements or modifications to assist the shift to a low-emission or energy-efficient economy may increase its competitiveness, while those lacking innovation may be obsoleted [3].

The importance of ESG investing is also reflected in improving financial market transparency. Papanthasiou et al. (2024) mention, that with the importance of environmental, social, and governance considerations in investment decisions being more widely acknowledged, the number of ESG investors has sharply increased over the past years [6]. Currently, consideration of ESG issues is accorded to investments for about 25% of all worldwide assets under management (AUM). Global ESG AUM totals are expected to be more than \$23 trillion [5]. This transfer from the profitability level to the “ethical business practices”, is regarded as one of the essential factors to rate a company, which goes beyond traditional financial analysis. Increased institutions and companies have started to reveal ESG investing reports, which offer a more holistic and transparent evaluation of a business’s performance. These reports usually cover many aspects of the environment, society, and governance, such as carbon emissions, attitudes about social issues, and the use of energy. It not only encourages businesses to commit to more ethical practices but also could help them enhance their reputation and market competitiveness. Especially in the context of the financial market's growing preference for green financial products, enterprises with good ESG performance and disclosure quality are more likely to be favored by investors, enjoying lower financing rates, higher market valuation, strengthening the momentum of sustainable business operations, and ultimately realizing the unity of maximizing corporate value and maximizing social value.

4. The Opportunities and Challenges of ESG

4.1. Opportunities

ESG investing could offer a wide range of opportunities for environment governance and finance development. Firstly, it is not just a financial strategy but a responsible approach to addressing global challenges and safeguarding future generations. From the perspective of sustainable finance, ESG investing goes beyond the traditional notion of simply maximizing short-term profits by incorporating environmental externalities into investment decisions and promoting capital allocation toward long-term ecological and social well-being. By fostering innovation to tackle global issues and promoting the development of a green economy, such as prioritizing lowcarbon emissions, ESG investing could serve as a catalyst for positive change. One evidence is that more business management teams seem to engage in environmental innovation and dedication to promoting eco-efficient product and service research and development, as well as the business's capacity to manufacture high-quality items and services intended for recycling, reuse, or other environmentally friendly practices [7]. Additionally, HSBC and Google Cloud recently launched a collaboration to speed up climate mitigation and resilience by providing funding and support to businesses participating in the Google Cloud Ready – Sustainability (GCR-Sustainability) initiative, which is an efficient program reducing carbon emissions, improving value chain sustainability, and processing ESG data to help identify climate risks [8]. These contributions show that ESG investing would have a deep influence on addressing environmental problems.

Another opportunity for ESG investing is that it may become a new investing trend and it is expected to replace traditional investing, which breaks the rigid stereotype that pursuing sustainability and profitability are mutually exclusive. The integration of ESG factors disrupts the traditional investment paradigm, revealing the compatibility and mutual reinforcement between financial performance and sustainable development goals. It makes it possible to conceive of a successful investment frontier as a three-dimensional object with maximum returns, risk, and social impact. In addition, empirical evidence supports that ESG practices are likely to make superior performance and its return is competitive. From 2010 to 2022, UK ESG equities mutual funds outperformed other sustainable investment options in the biggest European markets in terms of year-end returns and price strength [6]. Furthermore, Hill (2020) supported that the performance of sustainable funds “skews positive over both the short term and the long term”, and they “are competitive on price and performance” [5]. This superior performance might be a positive indicator to attract a growing number of investors to explore and adopt ESG investing as their preferred investment strategy. These findings suggest that ESG investing not only manages risk effectively, but also uncovers value creation opportunities ignored by traditional financial analyses, attracting more and more investors pursuing the dual goals of financial returns and social benefits.

4.2. Challenges

Although ESG investing plays an essential role in the environment and finance, some challenges cannot be ignored. While the standard of ESG investing is improving and more consensus is gradually being accepted, its system is not yet fully mature, particularly in terms of the ambiguity surrounding its definitions and criteria, which may lead to a certain degree of negative effects. On the one hand, despite the progress made in ESG analysis in assessing sustainability, it seems to have yet to overcome the inherent limitations of the traditional method, which is high skepticism and subjectivity. The traditional approach to identifying an ethical business often is referred to as the foreclosure approach, which subjectively filters and focuses on the products and specific corporate strategies to determine whether the company is ethical [2]. As Yébenes (2024) discusses, it is necessary and vital to set reliable ESG criteria due

to these standards orient organizations in the direction of ethical and sustainable behaviors instead of just being limited to financial considerations [3]. In fact, both the standards-setting process and the investor's decision-making phase are difficult. Credit rating agencies frequently have challenges in comparing and evaluating companies across sectors and geographies, due to the lack of uniform ESG reporting standards. Subjective interpretations and disparities in credit judgments may result from this inconsistency [3]. In other words, various ESG criteria and different characteristics in industries lead to subjective and reliable interpretations by analysts. On the other hand, the ESG-washing problem and disclosed data authenticity would pose significant obstacles in harmonizing expectations and performance for ESG investments. ESG-washing refers to an unethical practice in which managers frequently behave opportunistically and use investing strategies that deviate from SRI/ESG requirements [2]. Some firms take advantage of ESG's influence and investors' interests to achieve sales goals instead of ESG goals. For instance, listed steel companies like the Hegang, Angang, and Shougang groups were fined for environmental infractions in 2020 even though their ESG reports stated that there had been "no environmental violations" [9]. The ESG-washing problem might mislead investors and exaggerate claims about sustainability credentials, which perhaps is a major challenge that undermines the credibility of ESG investing. Liu et al. (2024) point out that corporate management is likely to satisfy the ESG preferences of overseas investors by only providing positive, high-quality ESG information [9]. However, some ESG greenwashing may escape regulation because most ESG disclosures are not audited by an independent third party currently, which leaves room for companies to manipulate or misrepresent their sustainability performance. This trend could lead investors to make adverse investment decisions based on incomplete or inaccurate information.

5. Conclusion and Future Prospects

In conclusion, as environmental issues have negative influences on businesses and even threaten humanity, social awareness has generally enhanced and the emergence of the young generation may accelerate ESG investing's development, which is crucial to addressing global problems and boosting the financial market. Despite the fact that ESG investing could encourage innovative practices to eliminate the impact of environmental problems and help investors select responsible and profitable companies, it may face some challenges as well. The unclear definition, standards, and analysis incur criticisms for its subjectivity. Furthermore, falsified data and ESG-washing problems may also hinder progress. Hence, it is vital to set reliable ESG criteria and impose more stringent regulations to improve its development. In addition, strengthening third-party verification mechanisms and improving transparency in ESG disclosures are essential to ensure the credibility of ESG investing. With the advancement of data technologies, such as big data analytics and artificial intelligence, ESG evaluation systems are expected to become more accurate, objective, and standardized, providing stronger support for sustainable investment decisions. Furthermore, enhancing the consistency and comparability of ESG disclosures across different markets and industries is equally critical for building long-term investor confidence. To achieve this, regulatory bodies and standard-setting organizations should strengthen global cooperation, promoting the establishment of unified disclosure frameworks and authoritative reporting standards. Meanwhile, increasing educational efforts and raising awareness of ESG principles among investors, corporations, and market participants will further facilitate the widespread adoption of ESG practices and ensure that sustainability considerations are effectively integrated into mainstream financial decision-making.

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