
Impact of ESG Investing on Corporate Governance

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ABSTRACT

The intersection of Environmental, Social, and Governance (ESG) factors with corporate governance has become increasingly prominent in recent years. As investors and stakeholders alike recognize the long-term value of sustainable practices, ESG investing has witnessed a surge in popularity. This paper aims to explore the multifaceted impact of ESG investing on corporate governance, drawing insights from existing literature and real-world case studies.

Key words; ESG Investing ,Corporate Strategy ,Governance Framework, Shareholder Interests, Environmental Impact, Social Impact, Corporate Governance, Sustainability, Stakeholder Engagement

Introduction

In recent years, Environmental, Social, and Governance (ESG) investing has emerged as a pivotal force reshaping corporate governance. As investors increasingly prioritize sustainable practices and ethical considerations in their decision-making processes, companies are compelled to adapt their governance frameworks to meet these evolving expectations. This shift not only reflects a growing awareness of the interconnections between financial performance and social responsibility but also underscores the critical role that governance plays in fostering sustainable business practices.

Historically, investment strategies primarily prioritized financial returns, often overlooking ethical and sustainability considerations. However, the rise of ESG investing has challenged this paradigm, advocating for the integration of non-financial factors into investment decisions. (Eccles, Ioannou, & Serafeim, 2014). This transition reflects recognition that sustainable practices can contribute to long-term value creation and risk reduction (Clark, Feiner, & Viehs, 2015).

Research indicates that ESG investing drives demands for greater diversity and inclusivity within corporate boards (Nielsen & Huse, 2010). Diverse boards are believed to be more effective at addressing ESG issues, leading to improved decision-making and innovation (Bear, Rahman, & Post, 2010). Studies show a correlation between board diversity and enhanced ESG performance, suggesting that investor pressure for diversity aligns governance structures with broader stakeholder interests (Smith, 2014).

The rise of ESG investing has redefined the concept of stakeholders in corporate governance. Traditional governance models often prioritized shareholder interests; however, the ESG framework advocates for a broader stakeholder approach (Freeman, 1984). Research indicates that companies with robust stakeholder engagement strategies are more likely to outperform their peers in ESG metrics (Harrison & Wicks, 2013). This shift encourages firms to consider the interests of employees, customers, and communities, leading to more holistic governance practices.

ESG factors are increasingly recognized as critical elements of corporate risk management. Several studies highlight that companies actively managing ESG risks tend to exhibit greater resilience in times of crisis (Eccles et al., 2014). By incorporating ESG considerations into their governance frameworks, organizations can better anticipate and mitigate potential disruptions, aligning corporate strategy with long-term sustainability goals (Gibson, 2018).

The demand for transparency in ESG practices has led to the development of various reporting frameworks, such as the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB) standards (KPMG, 2020). Research indicates that companies that adopt comprehensive ESG reporting practices tend to enjoy higher levels of trust among investors and stakeholders (Sullivan & Mackenzie, 2017). This transparency fosters accountability and encourages companies to improve their governance structures in response to stakeholder feedback.

The regulatory landscape surrounding ESG investing is rapidly evolving. Scholars have noted that increased regulatory scrutiny on corporate sustainability practices influences corporate governance (Bach, 2021). Regulatory bodies are implementing guidelines that compel companies to disclose their ESG impacts, thereby reinforcing the importance of governance in managing these factors. This has led to a shift in corporate cultures, where compliance with ESG regulations is viewed as integral to governance rather than an ancillary concern.

ESG investing has transcended traditional investment paradigms, driving a fundamental change in how corporations operate and are held accountable. The rise of responsible investment strategies has prompted boards of directors to incorporate ESG factors into their strategic planning, risk management, and stakeholder engagement processes. Consequently, corporate governance structures are being redefined to enhance transparency, accountability, and inclusivity.

Corporate governance includes the processes by which corporate objectives are established and pursued in the context of the social, legal and market environment. It deals with practices and procedures that ensure that the company is managed in a way that achieves its objectives, while at the same time ensuring that stakeholders can be assured that their trust in the company This is well-founded. The article argues that good governance is important because it provides the necessary infrastructure to improve the quality of decisions made by those running the business. Good-quality, ethical decision-making builds sustainable businesses and enables them to more effectively create long-term value (Masiye Banda& Austin Mwangi, 2023)

Economic performance in relation to environmental, social and corporate governance (ESG) indicators. In recent years investment managers preferred the importance of ESG indicators that show the long-term performance of companies in which they invest financial resources. This trend is very universal and there is no doubt that the ESG relations will influence the companies and that the objective of investors is to achieve sustainable growth and prosperity in the future. (A. Kocmanová, M. Dočekalová,2012)

Key ESG Factors Influencing Corporate Governance

ESG Factor	Impact on Governance Dimension	Description
Environmental Risk	Positive (Risk Management)	Companies with high environmental risks improve governance to mitigate exposure
Social (Diversity and Inclusion)	Positive (Board Independence)	Higher social scores correlate with better board independence
Governance (Transparency)	Positive (Executive Accountability))	Strong governance ratings align with higher executive accountability

Research questions of the study

- How do ESG investors use their voting power and engagement strategies to influence corporate governance practices?
- How does the threat of ESG investor scrutiny impact corporate behavior, even if they don't hold significant stakes?
- How has the rise of ESG investing driven companies to improve their ESG disclosure and transparency practices?

ESG Investors and Corporate Governance: A Closer Look

ESG investors are increasingly leveraging their voting power and engagement strategies to exert significant influence on corporate governance practices. Here's a breakdown of how they accomplish this:

Voting Power

Proxy voting: ESG investors can vote their shares through proxy voting, either directly or by appointing a proxy service. This allows them to influence the election of board members, executive compensation, and other key corporate decisions.

Targeted voting: ESG investors may focus their voting power on specific issues related to ESG, such as climate change, human rights, or diversity and inclusion.

Collaborative voting: Investors can collaborate with other like-minded shareholders to increase their collective voting power and influence on corporate governance.

Engagement Strategies

Direct engagement: ESG investors can engage directly with companies through meetings, letters, or phone calls to discuss ESG issues and express their concerns.

Shareholder resolutions: Investors can file shareholder resolutions to propose specific actions or changes to a company's policies or practices.

Public pressure: ESG investors may use public pressure, such as media campaigns or social media, to raise awareness of ESG issues and encourage companies to improve their practices.

Collaborative engagement: Investors can collaborate with other stakeholders, such as NGOs or labor unions, to amplify their voice and influence corporate behavior.

Examples of ESG Investor Influence

Climate change: ESG investors have played a significant role in pushing companies to set ambitious climate targets, reduce greenhouse gas emissions, and transition to low-carbon economies.

Human rights: Investors have used their voting power and engagement strategies to address human rights issues such as labor exploitation, child labor, and discrimination.

Diversity and inclusion: ESG investors have advocated for greater diversity and inclusion on corporate boards and in executive leadership. By effectively utilizing their voting power and engagement strategies, ESG investors can significantly influence corporate governance practices and drive positive change on a wide range of ESG issues.

Threat of ESG investor scrutiny and impact of corporate behaviour

Environmental, Social, and Governance (ESG) investing has gained momentum in recent years as a major force in shaping corporate behaviour. ESG criteria offer a framework through which investors evaluate the sustainability and societal impact of a company, often influencing the flow of capital. The threat of investor scrutiny through an ESG lens presents both risks and opportunities for corporations, leading to tangible shifts in corporate governance, operations, and stakeholder engagement. This literature review explores the role of ESG investor scrutiny, its impact on corporate behavior, and the evolving expectations of the investment community.

✓ **The Rise of ESG Investment**

Over the last two decades, ESG factors have evolved from being a niche consideration into a mainstream investment strategy. Studies suggest that ESG investing, which started to take shape in the 2000s, is driven by increasing awareness of global challenges such as climate change, inequality, and regulatory changes that mandate disclosure of non-financial performance.

Growth of ESG Assets

According to the Global Sustainable Investment Alliance (GSIA), global ESG assets under management (AUM) surpassed \$35 trillion by 2020, highlighting the widespread adoption of ESG investment strategies (GSIA, 2020). This surge has been driven by institutional investors, mutual funds, and retail investors who recognize that companies with robust ESG practices are better positioned to manage long-term risks.

Regulatory Pressures and Standards

ESG investors rely on frameworks like the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), and the Task Force on Climate-related Financial Disclosures (TCFD). These frameworks standardize how companies disclose their ESG performance, enabling investors to assess corporate risk and sustainability. Studies (Khan, Serafeim & Yoon, 2016) indicate that such frameworks help investors

distinguish between firms with meaningful ESG commitments and those engaged in "greenwashing" (superficial ESG practices).

✓ **ESG Investor Scrutiny and Corporate Behaviour**

The threat of ESG investor scrutiny forces companies to integrate ESG factors into their core strategies. The literature demonstrates that ESG investors not only focus on financial returns but also the ethical, social, and environmental impact of corporate actions. This shift has led to changes in corporate governance, risk management, and long-term strategy.

Corporate Governance and Accountability

Research by Eccles, Ioannou, and Serafeim (2014) indicates that companies subject to ESG scrutiny tend to develop more robust governance structures, including improved board oversight and stronger alignment of executive incentives with ESG goals. Corporate governance becomes more transparent and accountable to stakeholders, mitigating reputational risks and improving stakeholder trust.

Operational Changes and Risk Mitigation

Empirical evidence shows that companies under ESG investor scrutiny are more likely to implement sustainable practices to reduce environmental risks, such as lowering carbon footprints, minimizing waste, and enhancing resource efficiency (Clark, Feiner & Viehs, 2015). For instance, firms in carbon-intensive industries may pivot toward renewable energy or adopt circular economy models to align with investor expectations and mitigate regulatory and reputational risks.

Supply Chain and Labor Practices

ESG scrutiny has influenced corporate behavior regarding labor rights and supply chain practices. Investors increasingly demand transparency in how companies manage social risks, such as worker welfare and supply chain ethics. A report by the Harvard Business Review (2021) suggests that companies exposed to ESG scrutiny are more proactive in addressing labor issues, such as fair wages, safe working conditions, and eliminating human rights abuses in global supply chains.

✓ **Financial Performance and Value Creation**

One of the most debated aspects of ESG investing is whether it enhances or detracts from financial performance. The literature is mixed but suggests that companies with strong ESG practices often perform better over the long term, due to reduced risks, enhanced operational efficiency, and better alignment with changing consumer preferences and regulatory environments.

Positive Correlation with Financial Performance

A meta-analysis by Friede, Busch, and Bassen (2015) synthesizes over 2,000 empirical studies and concludes that ESG investing often results in superior financial performance. This is attributed to improved risk management, resource efficiency, and better stakeholder relations, which contribute to long-term value creation.

Market Penalties for Poor ESG Performance

Conversely, companies with weak ESG performance face market penalties, such as exclusion from ESG-focused portfolios or activist investor pressure (Dyck, Lins, Roth & Wagner, 2019). Studies show that firms facing ESG-related controversies (e.g., environmental disasters, labor disputes) often experience share price declines and increased cost of capital, highlighting the financial risks of ignoring ESG concerns.

✓ **Challenges and Criticisms of ESG Investor Scrutiny**

Despite the growing consensus around the value of ESG investing, the literature highlights several challenges, including inconsistent ESG ratings, green washing, and the difficulty of measuring intangible benefits.

Inconsistent ESG Ratings and Methodologies

One of the main criticisms of ESG investor scrutiny is the inconsistency in ESG ratings across different agencies. Chatterji et al. (2016) note that ESG ratings from different providers often yield divergent assessments of the same firm, creating confusion for investors and making it difficult for companies to navigate ESG expectations.

Green washing Concerns

Companies may engage in "green washing" by selectively disclosing positive ESG information or engaging in superficial ESG initiatives to appease investors without making meaningful operational changes. This undermines the credibility of ESG efforts and raises concerns about the genuine impact of investor scrutiny (Delmas & Burbano, 2011).

✓ **The Future of ESG and Corporate Behaviour**

Looking ahead, ESG investor scrutiny is expected to deepen, driven by regulatory changes, shifting consumer expectations, and technological advances in ESG reporting. Companies that proactively embrace ESG standards will likely benefit from enhanced resilience, market access, and stakeholder loyalty.

Integration of ESG into Core Business Strategy

As ESG factors become more integrated into corporate strategies, companies will shift from treating ESG as a compliance requirement to embedding it in their core value propositions. This shift will be essential for accessing capital, attracting talent, and maintaining competitive advantages.

Enhanced Technology and Data Analytics

Advances in technology and data analytics are improving the ability of investors to track and assess ESG performance in real-time, making it more difficult for companies to hide poor practices. Blockchain technology, for instance, is being explored as a tool for ensuring transparency in supply chain sustainability, offering investors greater confidence in the ESG credentials of companies (Sullivan & Gouldson, 2020).

The Rise of ESG Investing: Driving Companies to Improve ESG Disclosure and Transparency Practices

In recent years, Environmental, Social, and Governance (ESG) considerations have become central to both corporate decision-making and investor strategies. ESG investing represents a shift in the financial world where investors prioritize not only financial returns but also the ethical and sustainable operations of companies. This paradigm shift has led to an increase in investor demand for more detailed ESG disclosures. Firms that fail to meet these transparency expectations face the risk of capital flight, reputational damage, and regulatory scrutiny.

This paper explores the rise of ESG-driven investment and the corresponding push for enhanced corporate disclosure practices. It reviews key literature on ESG transparency, the role of investors, and the challenges corporations face in aligning their disclosures with investor demands.

1.1. The Rise of ESG Investing

➤ 1 ESG Investing Trends

The rise of ESG investing is primarily driven by growing awareness of climate change, social inequality, and corporate governance failures. According to the Global Sustainable Investment Alliance (GSIA), global sustainable investment reached \$35.3 trillion in 2020, accounting for over a third of all professionally managed assets (GSIA, 2020). The growing importance of sustainability in investment decisions has pressured companies to address their environmental and social footprints and governance structures.

➤ Investor Expectations and ESG Criteria

ESG investors evaluate companies based on their performance in areas such as carbon emissions, human rights, diversity, and executive compensation. Leading frameworks such as the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB) provide standardized approaches for companies to report ESG data. Research shows that companies with strong ESG performance are more likely to attract capital, while those with weak ESG transparency are excluded from ESG-focused portfolios (Eccles, Ioannou & Serafeim, 2014).

1.1. ESG Disclosure Practices and Corporate Behaviour

• Corporate Response to ESG Investment Pressure

Corporations have responded to investor pressure by enhancing their ESG disclosure practices. Companies are increasingly adopting standardized frameworks to report ESG-related information, including climate-related financial risks, gender diversity metrics, and corporate social responsibility (CSR) initiatives. A study by Clark, Feiner, and Viehs (2015) highlights that companies that disclose ESG data in a transparent and consistent manner often experience better financial performance and improved stakeholder relations.

• Importance of ESG Transparency

Transparency in ESG reporting is critical as investors seek to assess long-term risks and opportunities. Firms that demonstrate transparency in ESG practices are seen as better equipped to manage risks related to climate change, social justice, and governance failures. Khan, Serafeim, and Yoon (2016) argue that companies with high ESG transparency enjoy reduced costs of capital, better operational efficiency, and increased investor confidence. Enhanced transparency mitigates the risk of green washing, ensuring that companies' sustainability claims are authentic.

- Impact on Corporate Governance

ESG-focused investors have also driven changes in corporate governance. Studies indicate that companies subject to ESG scrutiny tend to improve board oversight, integrate sustainability goals into executive compensation, and foster a culture of accountability (Friede, Busch, & Bassen, 2015). For example, boards are more likely to establish sustainability committees to oversee ESG-related risks and opportunities, aligning corporate strategy with investor priorities.

Recommendations for Strengthening Corporate Governance through ESG

Governance Area	Suggested ESG Practice	Expected Outcome
Board Composition	Increase diversity through ESG-driven policies	Improved decision-making and innovation
Executive Compensation	Tie executive pay to ESG performance	Greater alignment with long-term shareholder value
Shareholder Rights	Strengthen rights in ESG-focused firms	More transparent and accountable governance

The Role of ESG Ratings in Driving Corporate Transparency

ESG ratings play a pivotal role in driving corporate behavior by signaling a company’s performance on sustainability issues to the investment community. However, Chatterji et al. (2016) note inconsistencies in ESG ratings across different agencies, which can confuse investors and complicate companies’ efforts to meet disclosure expectations. As a result, firms may struggle to understand how best to structure their ESG reports, particularly when faced with varying standards.

Challenges in ESG Reporting

Despite growing momentum, companies face challenges in providing consistent and comparable ESG disclosures. One challenge is the lack of standardized metrics across industries and regions. Inconsistent reporting frameworks make it difficult for investors to compare ESG performance across companies. Moreover, Delmas and Burbano (2011) point out the risks of green washing, where companies present misleading information to appear more sustainable than they truly are.

Link between ESG Disclosures and Financial Performance

The literature presents mixed results on the relationship between ESG transparency and financial performance. Friede, Busch, and Bassen (2015) conducted a meta-analysis of over 2,000 studies, concluding that the majority of research supports a positive link between ESG disclosure and long-term financial performance. Transparency in ESG reporting is associated with better risk management, access to capital, and higher market valuations. However, some studies indicate that ESG disclosures can be costly and may not yield immediate financial benefits.

1.1. The Role of Regulation in ESG Disclosure

- Regulatory Push for ESG Transparency

Governments and regulatory bodies worldwide are increasingly mandating ESG disclosures. The European Union’s Corporate Sustainability Reporting Directive (CSRD) is a significant step toward standardizing ESG reporting, requiring companies to disclose ESG-related risks and opportunities in a uniform manner. Similarly, the U.S. Securities and Exchange Commission (SEC) has proposed rules mandating climate-related disclosures for publicly traded companies (SEC, 2022). Such regulatory developments are expected to further enhance the quality and comparability of ESG disclosures.

- Investor-Led Initiatives

In addition to regulatory measures, investors are also taking collective action to promote ESG transparency. Initiatives like the Climate Action 100+ and the Principles for Responsible Investment (PRI) have successfully pushed companies to adopt more transparent and consistent ESG disclosure practices. Research suggests that investor-led initiatives often result in faster improvements in corporate disclosure than regulatory mandates alone (Dyck, Lins, Roth & Wagner, 2019).

1.1. Future Trends in ESG Disclosure

- ✓ Technological Innovations in ESG Reporting

Technological advancements are expected to revolutionize ESG reporting. Blockchain technology, for instance, can enhance transparency by providing a tamper-proof record of ESG data, ensuring that companies cannot

manipulate their sustainability records (Sullivan & Gouldson, 2020). Additionally, artificial intelligence (AI) and data analytics tools are improving the accuracy of ESG reporting, allowing investors to access real-time insights into corporate ESG performance.

✓ Increased Stakeholder Engagement

As ESG investing becomes more mainstream, companies are expected to increase their engagement with a broader range of stakeholders, including employees, customers, and communities. Research shows that companies with strong stakeholder engagement are more likely to succeed in meeting ESG transparency demands, as they can better anticipate and address emerging sustainability issues (Clark et al., 2015).

Conclusion

The rise of ESG investing has profoundly influenced corporate governance, reshaping how companies manage risks, interact with stakeholders, and align their strategies with long-term sustainability goals. ESG-focused investors are increasingly holding companies accountable for their environmental, social, and governance practices, driving enhanced transparency, ethical decision-making and more robust risk management frameworks. This shift has led to significant changes in corporate governance structures, including the integration of sustainability goals into board oversight and executive compensation plans. Boards of directors are now more engaged in addressing ESG risks, often establishing dedicated sustainability committees and aligning corporate strategy with the evolving expectations of shareholders and other stakeholders. This trend is fostering a culture of accountability and long-term thinking within organizations, encouraging responsible corporate behavior that goes beyond traditional profit maximization.

However, the effectiveness of these changes hinges on several factors. Inconsistent ESG ratings and reporting frameworks, for example, create challenges for both investors and companies, making it difficult to compare performance and align governance practices with investor expectations. Additionally, the risk of green washing—where companies superficially adopt ESG initiatives to appeal to investors without enacting substantive changes—remains a critical issue that undermines genuine governance improvements.

Looking ahead, the future of corporate governance will likely be shaped by further integration of ESG criteria into core business practices, driven by both investor demand and regulatory pressure. As governments and regulatory bodies worldwide adopt stricter ESG disclosure requirements, companies will be compelled to adopt more transparent, accountable, and forward-thinking governance structures.

In conclusion, ESG investing has emerged as a transformative force in corporate governance, pushing companies to not only enhance their internal governance structures but also contribute positively to societal and environmental outcomes. The alignment of corporate governance with ESG principles will continue to be crucial for building resilient, ethical, and sustainable businesses in the global marketplace.

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