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The Impact of ESG Factors on the Firm Performance

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Abstract: This paper examines the impact of environmental, social, and governance (ESG) factors on corporate behavior and performance. Amid increasing concerns from stakeholders, companies are pressured to prioritize ESG aspects. This study leverages stakeholder theory, which emphasizes balancing all stakeholder interests over solely maximizing shareholder wealth. A significant shift was noted in 2019 when U.S. business leaders endorsed a "Statement of Purpose" emphasizing societal benefits over shareholder interests, reflecting a broader move towards corporate social responsibility. The paper analyzes ESG's influence on three key areas: investor expectations, risk management, and long-term strategy. It highlights the mixed research findings on the correlation between ESG ratings and stock prices, noting emerging studies that explore behavioral biases in investor decisions. In terms of risk management, ESG practices are increasingly integral, with research showing that higher ESG ratings can reduce default risks. Regulatory risks are also discussed, particularly concerning climate change policies. Furthermore, the paper explores how sustainability, driven by investor and consumer activism, is becoming central to corporate long-term strategies. Models like the ISM and concepts like double materiality are used to demonstrate how ESG factors can optimize corporate performance. Ultimately, the study concludes that ESG elements significantly impact corporate behavior, suggesting a positive correlation with firm performance.

Keywords: ESG Factors, Corporate Performance, Sustainability, Risk Management.

1. Introduction

The growing concern among investors, employees, suppliers, and governments regarding the risks associated with the environment and other non-financial factors such as social responsibility and corporate behavior has exerted significant pressure on enterprises to prioritize ESG aspects. Companies provide feedback on their specific performance in relation to these risks across three categories: environmental, social, and governance (ESG). The most discussed issue in corporate committee or board meetings revolves around investment reasonability or resource allocation. This paper aims to elucidate how ESG factors impact corporate behavior.

The fundamental principle of stakeholder theory posits that an organization should strive to strike a balance between the interests of all stakeholders, rather than solely focusing on the wealth accumulation of a single shareholder or its own financial performance. Enterprise managers ought to comprehend and respect all organizational behaviors and individuals involved, while also prioritizing social benefits [1].

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On August 19, 2019, the chief executives of 181 leading U.S. companies collectively endorsed the "Statement of Purpose" at the Business Roundtable, a prominent American business organization based in Washington. The declaration redefined the core objectives of corporate operations by asserting that shareholder interests were no longer paramount and that fostering a better society became the primary mission for companies.

The significance of this declaration lies in its response to society's growing demand for corporate social responsibility and sustainable development. It reflects business leaders' profound understanding of enterprises' original intentions, their relevance to society and stakeholders, as well as their role in promoting social progress and environmental harmony. This statement provides new and explicit guidance, marking an end to an era where maximizing shareholder value was considered the sole creed of businesses. Instead, it paves the way for creating multiple shared social and environmental values alongside economic prosperity.

Academics and businesspeople have long debated the effects of ESG performance on organizational value and profitability. Numerous studies have examined the connection between environmental performance—such as biodiversity and climate change—and stock values. Health, safety, and welfare are among the many things that have been underlined recently with the rise of global health challenges.

This study looks at how the financial industry has changed significantly as a result of the tremendous advancement of ESG factor research and its implementation. Using both recent and historical study instances, this article attempts to explain how ESG issues affect company behavior from three perspectives: long-term strategy, risk management, and investor expectations.

This is how the remainder of the paper is structured. The previous study on investor expectations is covered in Section 2. The topic of ESG variables influencing risk management is covered in Section 3. The topic of ESG aspects in long-term planning is covered in Section 4. The conclusion and recommendations for more research are covered in Section 5.

2. Investor Expectation

In this section, this paper will first introduce ESG rating. ESG ratings typically identify industry leaders from laggards based on a set of rules, with businesses ranked from "AAA" to "CCC" according to how much they manage risk and how exposed they are to social, environmental, and corporate governance issues. This provides insight into potential ESG risks to make better investment decisions and communicate with clients.

ESG factors are valued because of their impact on stock prices. There is considerable research on this, although there is disagreement as to whether it is a positive effect. Some studies believe that ESG rating is positively correlated with stock returns, while other research indicates that there may not be a meaningful association between them [2].

It is also worth noting that in addition to the relatively traditional research on whether ESG has a positive effect on stock prices, some emerging studies provide more research directions and optimization space in related fields by using new methods. Leite et al. looked at the moderating effects of behavioral bias on investor decisions affecting ESG stock pricing in an effort to close the gaps in the literature [3]. In particular, this article conceptualizes and demonstrates how, in the presence of favorable news, stock valuations may become more biased due to the perception of a company's non-monetary qualities, which are represented by a high ESG score. This, in the end, will reflect investor expectations. Their results indicate that the deceleration effect of positive ESG evaluations is substantial only in the case of credit rating upgrades. This opens up new avenues for ESG factor study [3].

Compared with Leite et al.'s research, Taparia' s research is more extensive. In addition to the differences in investor expectations, preferences and behaviors bias, Taparia's paper also shows the

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relevant model of sustainability and possible existence of misguided situation [4]. Through a large number of previous studies, this paper has obtained many investor preference models related to sustainability. ESG investors promote the conversion of brown enterprises to green enterprises, which is indeed a typical example of ESG factors affecting corporate behavior. The idea is that green businesses may acquire capital more cheaply and are valued highly, which forces brown businesses to turn green and eventually makes them more ecologically friendly. Also, this paper also carries on the literature analysis in the fund aspect: Hartzmark and Sussmann's research focuses on the performance of ESG and mutual funds [5]. They found no evidence that, after adjusting for well-known risk factors, mutual funds with high sustainability ratings performed better than those that ranked lower on the ESG dimension. Their research draws on the Morningstar sustainability rating, which was introduced in 2016. In contrast to this evidence, According to Ammann et al.'s study, sustainable funds perform better when evaluated over an extended period of time [6]. Nonetheless, the results of researches indicated that funds with better sustainability ratings attracted more capital inflows than those with lower rankings, supporting the notion that investors are generally more likely to make sustainable investments. On the whole, the content of this paper covers more, compared with the traditional research, it puts forward many new research results.

Overall, a sizable number of papers pertaining to ESG are available. The majority of earlier research concentrated on the connection between stock returns and ESG ratings. Research findings vary widely because of the imprecise nature of the ESG rating system, making it impossible to accurately assess how well businesses are performing with respect to certain social, political, and environmental elements. These new study paths and accomplishments, however, fill in the gaps left by earlier studies and offer fresh directions for future research in this subject. Some developing studies introduce new ideas, such as investor expectation or behavior bias.

3. Risk Management

When considered comprehensively, environmental, social, and governance (ESG) practices are an evaluation of a business, their effects, and the business's advancement in comparison to its foundation. Given that a variety of stakeholders are concerned about a company's ESG performance, investors and lenders, for instance, may depend on ESG data (ESG scores or ratings) to assess a company's risk exposure and its anticipated future financial performance. It follows that ESG is beneficial in and of itself as a risk management initiative.

According to many relevant studies, good risk taking and management can accelerate the accumulation of enterprise capital. From a macro perspective, the improvement of the overall level of economic and social risk-taking means the increase of the level of capital expenditure. In the past, there were various researches on enterprise risk management, mainly because its characteristics changed with The Times, and the enterprise risk management would change with the external environment.

It is important to note that in 2024, ESG-related risk management is no longer just a compliance requirement but a corporate strategy requirement. By moving from passive acceptance to proactive risk taking, companies can ensure sustainable growth and make a positive impact on the world by putting environmental, social and corporate governance principles at the heart of their strategy. Among these risks, default risk and regulatory risk are the more important parts.

Li et al. discovered in 2022 that while a substantial body of research has been done on the connection between corporate risk ratings and CSR or environmental, social, and governance investments, there is a dearth of data regarding whether or not these investments are valued in the credit market [7]. Default risk is undoubtedly connected to credit markets. In order to close the gap in relevant literature, the researchers looked at how ESG practices function in the loan market [8]. They discovered that Chinese listed businesses with better ESG ratings had a reduced default risk,

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and that the risk reduction benefit grows as risk duration increases. This positive effect shows that the credit market can well reflect the ESG practice of enterprises.

As for regulatory risks, it is not difficult to see from the relevant documents that they mainly come from ESG-related policy changes, the most important of which is the impact of climate change. Numerous regulatory arrangements and changes have taken place globally. For example, the UK government has committed to achieving a net-zero economy in all of its regulatory activities by 2050. The U.S. Securities and Exchange Commission has announced the formation of Working Groups on Corporate Governance, Social and Environmental Issues, and Climate Change in 2021. Due to the work of the task force, the SEC has filed disclosure charges pertaining to corporate governance, social issues, and the environment against a number of well-known public corporations. Furthermore, the SEC proposed new regulations in 2022 mandating that corporations registered both domestically and internationally disclose information connected to climate change in their registration statements and annual reports. Additionally, the SEC put up new regulations to fortify the legal framework governing investment funds' and investment advisers' disclosure of their corporate governance, social, and environmental investing objectives.

There are many ways in which companies can deal with regulatory risk. For example, training, because ESG design issues can affect multiple business areas, internal functions and even the board of directors, cannot be left to industry experts alone, but the company as a whole. Another important measure is the arrangement for whistleblowing. Since the ESG field also has a considerable emotional impact, and the attention paid to whistleblowing by regulators, this means that companies may be facing complaints about ESG-related issues, whether from internal employees or external customers, shareholders, etc. In August 2021, for example, the SEC launched an investigation into the asset management arm of a financial institution after a whistleblower accused the institution of misrepresenting its environmental, social, and corporate governance credentials to clients and investors. It is therefore important to ensure that appropriate whistleblowing arrangements are in place, including proper investigation of relevant issues in accordance with due process.

While ESG offers opportunities for financial service providers, it also brings with it a number of regulatory risks that should be properly considered and managed. As mentioned above, firms should put in place arrangements to effectively manage ESG risks before issues arise, including training, dealing with whistleblowing, and so on. In the event of a breach, firms should stop and investigate immediately, and even conduct record-keeping.

4. Long-Term Strategy

ESG factors also have a profound impact on a company's long-term strategy, and this impact comes from sustainability [9]. Sustainability is important for companies to remain relevant and competitive in the world, and similar to digital transformation, Sustainability ought to play a significant role in a business's long-term strategy. This is the outcome of investor and consumer activism: by 2020, 91% of banks will track the ESG performance of their assets. When choosing an investment, 85% of investors will consider ESG factors. In a recent letter, the CEO of BlackRock, the biggest asset management in the world, expressed investor concerns on sustainability. According to Larry Fink, sustainability is about making long-term, sustainable profits as much as doing the right thing. A Deloitte study indicates that over 60% of UK consumers have cut back on single-use plastics in an effort to lead more environmentally friendly lives. A third of consumers in the UK prefer brands that have a solid track record of sustainability. Given that demand for sustainability is only likely to grow globally, every company hoping to remain relevant in the future will need to include sustainability into its corporate strategy.

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As mentioned above, investors no longer focus only on profits, but on non-financial parameters such as ethics, which investors analyze to determine profits and rates of return [10]. In short, ESG investment is the intermediary between sustainable development and the financial system.

Often researchers will use some kind of model analysis to select suppliers, such as the ISM model (Interpretive structure Model), which can identify the association between various factors that affect the decision when a particular problem arises. Taking Governance as an example, ISM model can conduct relationship links according to ESG elements, such as human rights, policies, employee relations, etc. introduced by Governance, and can further infer the company's macro income, business and environment relations, etc. Therefore, through the research and analysis of ISM model, the sustainability of the company can be demonstrated, and such technology has a positive impact on the company: The company's own ESG status becomes transparent and investors attach importance to non-financial factors such as sustainable development, prompting the company to reform and optimize its policies, business and other aspects. Overall, there's little doubt that this optimizes the company's performance in a beneficial way.

Double materiality can support the relationship between ESG and the SDGs. "Materiality" in this paper refers to the data that businesses have to give investors. The impact of an omission or untruth on the customer's overall perception of the information determines how essential the information is. To summarize Double Materiality, double materiality is the efforts of the bottom company to improve its sustainable development performance at the corporate level. In the long run, if these efforts can be effectively implemented and benefit the stakeholders of the company, the stakeholders at the upper level can help the bottom company's finance in turn, which is a two-way process. In the long run, a company's long-term strategic pursuit of what is good for society can have a positive impact on investors.

There has been a change in the focus of sustainability, moving from ecological sustainability to an environmental strategy with systemic effects on the economy, society, and environment, and finally to a three-position structure based on social equity, economic integrity, and environmental integrity. Sustainability has always been acknowledged as the ultimate goal of business, despite definitions changing over time. Meeting stakeholder expectations, which are typified by ESG problems, and the positive and negative consequences of company operations on society and the environment are the main factors that define sustainability at the corporate level. Consequently, sustainability and long-term company strategy may be impacted by ESG.

In general, there is an unbreakable link between corporate sustainability and ESG aspects; this relationship extends from the micro level of a company's sustainability to the macro level of the SDGs. As a result, models like the ISM, Double Materiality, etc., can help a company navigate the unmanageable space of sustainability and determine how its sustainability initiatives can help it reach its sustainability goals, and ultimately, give direction to its strategy.

5. Conclusion

By integrating a substantial body of prior research, we examine the three primary ESG elements influencing business behavior in this study with regard to investor expectations, risk management, and long-term strategy. ESG factors are generally a growing global concern. Investors and other stakeholders use them as evaluation criteria, and as a mainstream global development direction, they drive businesses to create long-term strategies for them while maintaining risk management. The majority of research demonstrate a positive correlation between corporate performance and ESG elements, i.e., more good corporate behavior might result from ESG aspects.

For example, State Street's earlier ESG Investment Statement discussed the shift to a low-carbon, more sustainable, resource-efficient, and circular economy. Later on, though, the definition of ESG problems was changed to include "events or conditions that, if they occurred, could negatively impact

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the value of an investment." In addition, Henry Fernandez, CEO of MSCI, a well-known source of ESG ratings, claims that most individuals, a large number of institutional investors, and even some portfolio managers are confused by the double-speak around ESG.

As passive funds continue to gain traction, asset management income as a percentage of asset management size has dropped throughout the last five years by 4.6 basis points, according to The Boston Consulting Group. Derivatives like fees associated with ESG goods benefit from this decline as well. Because their fees may be up to 40% higher than those of regular funds, ESG funds have been able to quickly address the narrowing of asset management margins. These extra costs are sometimes unnecessary, since ESG funds are often fairly comparable to "regular" funds.

There are signs that there is still a large segment of the population that is more interested in shareholder benefits and investment opportunities than in ESG itself, which is an emerging global trend that still needs to be addressed by governments, corporations, and others in order to make it a tool for global ecological and social development, rather than a profit-making tool for capitalists.

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