Available Online: 18 April 2025 DOI: 10.54254/2977-5701/2025.22201

What is Environmental, Social and Governance (ESG) investing and why is it important?

Hanmei Liang

Dongbei University of Finance and Economics, Dalian, China

3043880977@qq.com

Abstract. This paper explores the definition, significance, opportunities, and challenges of Environmental, Social, and Governance (ESG) investing, supported by real-life examples. ESG investing not only promotes corporate sustainability but also facilitates effective risk management, as demonstrated by the case of APG Asset Management, which reduces investment risks through climate risk assessments. The opportunities of ESG investing lie in stimulating corporate innovation and enhancing brand value. However, it also faces challenges such as fragmented data, inconsistent rating standards, and corporate greenwashing, exemplified by Tesla's greenwashing incident in 2022. To overcome these challenges, concerted efforts from companies, investors, government regulators, and rating agencies are needed. These include companies genuinely practicing ESG principles, investors focusing on sustainability, governments expediting clear regulations, and rating agencies improving data quality and transparency. Despite numerous difficulties, the future of ESG investing is promising, with the ultimate goal of achieving a win-win situation for corporate health and environmental improvement.

Keywords: ESG investing, sustainable development, risk management, greenwashing

1. Introduction

In today's era, ESG standards are increasingly becoming a primary criterion for investors when making investment decisions, highlighting a growing emphasis on environmental, social, and governance factors. So, what is ESG investing? ESG stands for environmental, social, and governance. ESG investing refers to how companies score on these responsibility metrics and standards for potential investments. Environmental criteria gauge how a company safeguards the environment. Social criteria examine how it manages relationships with employees, suppliers, customers, and communities. Governance measures a company's leadership, executive pay, audits, internal controls, and shareholder rights [1]. The significance of ESG investing extends beyond mere compliance; it is a strategic approach that fosters sustainable development and mitigates risks. However, there are some shortcomings in ESG investing at the moment. Remedying these deficiencies requires the joint efforts of all stakeholders. And this essay will be structured into four parts: firstly, the important role of ESG in sustainability and risk management, which gives an example with APG's risk management; secondly, the opportunities in impetus for innovation and enhancement of corporate reputation and brand value; thirdly, the challenges of ESG integration, giving an example with the case of Tesla; and fourthly, strategies to overcome these obstacles from various stakeholders' perspectives.

2. Literature review

In recent years, Environmental, Social and Governance (ESG) investment has become an important research direction in the field of finance as the global focus on sustainable development has increased. Many scholars have conducted in-depth discussions on the theoretical basis, practical effects and challenges of ESG investment from different perspectives, providing a rich theoretical and empirical basis for this study.

ESG is so important not only because it is an important investment strategy but also because it is a guiding light to promote the healthy development of enterprises. Gaganis et al. [2] have emphasized that climate change is a major topic in sustainable finance. With the emergence of environmental problems such as global warming and the reduction of biodiversity, it has become a consensus to protect the environment, reduce pollution, and adhere to sustainable development. However, sustainable development cannot be achieved without enterprises. So, the first importance of ESG investing is to promote the sustainable

Copyright: © 2025 by the authors. Submitted for possible open access publication under the terms and conditions of the Creative Commons Attribution (CC BY) license (https://creativecommons.org/licenses/by/4.0/).

development of enterprises. Why can ESG investing promote enterprise sustainability? From a corporate perspective, financing is an important part of enterprise development. In order to gain easier access to financing, companies need to improve their sustainability capabilities to improve their ESG scores. To improve sustainable development, we must adhere to green and environmentally friendly production methods, pay attention to managing relationships, and actively assume social responsibility. Friede et al. [3] have found that governance displays the strongest correlation with positive financial performance. And According to Hill, 88% of reviewed sources found that companies with robust sustainability practices demonstrate better operational performance, which ultimately translates into cash flows. These two surveys show that governance and society cannot be ignored in the process of corporate sustainable development. All in all, ESG investment has played an important role in promoting the development of enterprises in the direction of sustainable development and actively assuming social responsibility.

In addition to promoting corporate sustainability, the second importance of ESG investing is to promote active risk management, which is the process of identifying, evaluating, prioritizing, and monitoring uncertainties and potential events that may affect the achievement of an organization's goals. Why can ESG investing facilitate risk management for businesses? Every decision made by the enterprise may increase its risk. Therefore, in order to reduce the risk of the business, the company must have a clear target plan, have a good management team, and be cautious when making decisions. Especially for those companies that are not aware of the importance of risk management, the introduction of ESG indicators can prompt them to pay more attention to risk management, thereby reducing the investment risk of investors and the operational risk of enterprises. For risk management, this essay finds a successful case. APG Asset Management is a trust asset management company for pension funds with a strong focus on risk management, particularly in managing climate risks and opportunities. It monitors and manages climate-related risks and opportunities by establishing climate steering groups and using scenario analysis. Then, it uses the results of the analysis to invest, reducing the risk of the investment. As stated by Gaganise et al. [2], ESG should be an integral part of corporate strategy within and outside the financial industry to ensure long-term success. This highlights the importance of ESG in the investment process.

The opportunities for ESG investing are mainly reflected in two aspects: stimulating corporate innovation and enhancing competitive advantage and brand value, which are essential for the company to attract investment and secure long-term business. Innovation determines the survival and development of enterprises [4]. Investors usually don't choose to invest in companies that don't have growth prospects. ESG investment incentivizes companies to innovate and promote the development of new products and services, thereby promoting the sustainable development of enterprises, which helps enterprises continuously improve their market position and core competitiveness and brings more opportunities to investors. Moreover, ESG investment also drives a company's reputation and brand value, which is one of the key factors affecting brand trust and customer loyalty today. And it is also considered one of the intangible assets of a company. By practicing ESG principles, companies can build and maintain a positive brand image, which can enhance customer stickiness and loyalty. This provides more opportunities for businesses to gain a competitive edge in the market and maintain solid business growth in the long term. What companies need to do is seize the opportunities brought by ESG investment, continue to push themselves forward, and enhance their core competitiveness.

Although ESG investing presents opportunities, it also presents challenges. The fragmentation of ESG data and rating standards and corporate greenwashing pose significant challenges to ESG investing by complicating company assessments and potentially misleading investors. Currently, most data are self-reported by companies, with often questionable consistency and metrics, and vendor ESG ratings are often inconsistent [5]. This is the major challenge for ESG investment. A variety of different rating criteria, such as Morgan Stanley Capital International, Morningstar, and Bloomberg, lead to differences in the ESG criteria used by different companies. This makes it impossible for investors to compare data between companies that use different ESG rating criteria, limiting their assessment of ESG performance and investment decisions. Additionally, determining whether a company is truly compliant with ESG standards is another challenge facing ESG investing. The essay gives a negative example. Tesla has a serious "greenwashing" phenomenon in 2022. Greenwashing is an action by companies that are, or appear to be, ethical or environmentally friendly, but in fact rather try to cover up some unethical actions, an environmental problem, or even a disaster caused by the company [6]. Tesla generated hundreds of millions of dollars in revenue in 2022 by selling carbon credits, but the Institute of Public and Environmental Affairs investigation found that several of Tesla's suppliers had environmental violations, which ran counter to Tesla's promoted environmentalism. This is just a counterexample; there are many companies in the market that engage in green washing. The occurrence of this phenomenon undoubtedly increases the investment risk of investors. While these challenges have hindered the development of ESG investing, the ultimate goal is to overcome them and move them forward.

As we move forward, overcoming these challenges requires the concerted effort of all stakeholders. Firstly, companies must truly adopt and demonstrate ESG practices, not just marketing, to avoid greenwashing. Hill [5] has discovered that less than 5% of the world’s publicly listed companies report their emissions. Companies need to increase their efforts to disclose issues to the public to reduce risk for investors. Companies also need to increase their care and development for their employees. No matter the size of firms, empowering employees to make decisions about the culture and even about your ESG strategy can support your employees’ growth [4]. Secondly, investors should focus on sustainability and reduce their risk exposure. In terms of the environment, investors can reduce their investment in carbon-intensive industries by differentiating the risk weights between low-carbon and carbon-intensive industries, which in turn will make them pollution-free [2]. In terms of social and governance, investors should be critically thinking and not only judge risks based on ESG criteria but also pay attention to on-site inspections, such as employee interviews, investigating the company's contribution to society, etc. This can avoid decision-making errors to a certain extent. Thirdly, government regulators should expedite the establishment of clear regulations to regulate the conduct of companies. Despite this, it is also necessary to accelerate the harmonization and unification of ESG standards to increase the

practicability of ESG standards. Fourthly, rating agencies need to accelerate the harmonization of rating standards and make rating decisions and frameworks more transparent. It is more noteworthy that rating agencies need to ensure the quality of data to improve the accuracy and credibility of ESG ratings. We believe that through these initiatives, stakeholders can work together to promote the development of ESG investment and achieve sustainable development.

3. Conclusion

To sum up, ESG investment encourages companies to innovate, strengthen internal management, and improve their sense of responsibility to society. The implementation of these initiatives will enhance the company's reputation and brand value, thereby promoting sustainable development. At the same time, ESG provides investors with a set of criteria to evaluate companies, which allows investors to better identify the risks to which companies are exposed, thereby reducing investment risk. While ESG standards are a good indicator, they also present some challenges that cannot be ignored. Overcoming these challenges will require a concerted effort by all stakeholders. Although the future of ESG investing may face many difficulties, the future of ESG investing is bright. Our ultimate goal is to shape a world where businesses are healthy and financially stable and the planet is getting better.

References

[1] Investopedia. (2024). What Is ESG Investing? https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp#toc-esg-metrics

[2] Gaganis, C., Pasiouras, F., Tasiou, M., & Zopounidis, C. (Eds.). (2023). *Sustainable Finance and ESG: Risk, Management, Regulations, and Implications for Financial Institutions.* Springer International Publishing AG.

[3] Friede, G., Busch, T., & Bassen, A. (2015). ESG and financial performance: aggregated evidence from more than 2000 empirical studies. *Journal of Sustainable Finance & Investment, 5*(4), 210–233. https://ideas.repec.org/a/taf/jsustf/v5y2015i4p210-233.html

[4] Schreane, K. C. (2022). *Gambling on Green: Uncovering the Balance among Revenues, Reputations, and ESG (Environmental, Social, and Governance).* John Wiley & Sons, Incorporated.

[5] Hill, J. (2020). *Environmental, Social, and Governance (ESG) Investing: A Balanced Analysis of the Theory and Practice of a Sustainable Portfolio.* Elsevier Science & Technology.

[6] Meinhold, R. (2021). *Business Ethics and Sustainability.* Taylor & Francis Group.