Problems of ESG that Prevent Its Integration in Investment Decision-Making: Evidence from Investors

Kaiting Chen *

Shenzhen Foreign Language School, Shenzhen, China

* Corresponding Author Email: kaitingchen2028@u.northwestern.edu

Abstract. The growing importance of ESG considerations in investment decisions reflects a transformative shift in how investors evaluate the sustainability and ethical impact of firms. As ESG integration becomes increasingly popular among investo rs, it is important to analyze how such an integration can affect investment decisions. While previous articles discussed reasons why investors integrate or not integrate ESG in making investment decisions, they did not probe into the question of how problems of ESG itself affect its integration in investment decision-making. This essay explores this topic by analyzing previous articles about ESG, its traits, and investors' views on taking into account ESG factors in investment decision-making. It is concluded that some problems of ESG, including the absence of agreed criteria and lack of transparency in the rating process, can prevent ESG integration from being effective in making investment decisions.

Keywords: ESG integration, investment decision-making.

1. Introduction

Environment, Social, and Governance (ESG) is a set of standards for a company's conduct that socially conscious investors use to asses potential investments. ESG integration is the act of including analysis of ESG factors in making investment decisions, usually by evaluating the companies' ESG ratings. In recent years, the landscape of investment decision-making has undergone a significant transformation, driven by the growing awareness of ESG factors. A large number of companies, including 58% in the S&P 500 Index, are now publishing ESG reports [1]. Investors all over the world have recognized the importance of including ESG analysis in their portfolios, aiming not only for financial returns but, more importantly, for the promotion of sustainable and ethical practices. In order to direct investors' funds to businesses that are performing well based on published ESG metrics, new investment vehicles and investment advisory groups have been established [1]. This shift in perspective, carrying people's hope for an environmentally friendly future, has been lauded for its potential to align investments with broader goals of humanity and to mitigate long-term risks arising from environmental and social challenges.

However, despite the widespread acknowledgment of ESG's significance, its integration into investment decision-making remains elusive. A great gap exists between the principles of ESG integration and the actual application of these principles in investment strategies. There is already a wide range of articles about ESG integration, but none of them provide a comprehensive analysis of factors that may prevent ESG integration. Using data from investors and market participants, this essay explores the complex issues that prevent the effective inclusion of ESG considerations in investment decision-making. It is hoped that this essay can provide a clear view of the major problems of ESG integration and develop suggestions that can help build a more effective and widely accepted version of the ESG rating system.

To accomplish this goal, this essay examines previous articles about ESG integration, extracts the problems of ESG that are mentioned the most, compares similar views and contrasts conflicting ideas, and finally provides suggestions, which involve worth for policymakers, of possible ways to deal with the problems found and promote the future development of ESG in investment.

2. Analysis of the Problems

By examining data and investors' opinions from previous articles about ESG integration, the major obstacles that prevent effective ESG integration are concluded and analyzed below:

2.1. Violation of Fiduciary Duty

In a financial sense, fiduciary duties are duties of asset managers to act in their beneficiaries' interests rather than their own interests. With fiduciary duty, the responsibility of asset managers is to manage their client's assets in a way that maximizes the client's interests. According to Joakim Sandberg, it has been subjected to intense debate whether the institutional investors' fiduciary duties are reconciled with purposefully taking ESG considerations into account [2]. The primary disagreement underlying this debate is whether or not financial returns should be prioritized in making investment decisions. Those who support prioritizing financial returns claim that taking ESG factors into account may affect financial returns, as those companies that outperformed others financially may not be the ones that are environmentally friendly. According to Langbein and Posner, the fiduciary duty is supported by the obligation of responsible investment, which prohibits the trustee from investing for any purpose other than maximizing the return, and with ESG factors integrated in making investment decisions, fiduciary duty would be violated [3]. Therefore, according to the definition of fiduciary duty, since ESG integration can result in failure to maximize the client's interests, it violates the principles of fiduciary duty. However, there are also investors who believe ESG integration does not violate but aligns with fiduciary duty. According to Fabio Moliterni, many asset managers in Europe have stated that taking ESG into consideration is part of their investment requirements, which are associated with their fiduciary duty [4]. Given that investors have control over determining investment approaches to fulfill their fiduciary duties in most jurisdictions, recent changes in the economic and market environment have made ESG integration a viable strategy for reducing risks and generating positive financial returns. In fact, taking ESG factors into account allows investors to evaluate the risks and opportunities associated with a particular investment more comprehensively, enabling a more accurate assessment of the profitability of the firms. In short, since ESG integration can reduce risks, and risks can affect financial returns, integrating ESG in investment may actually increase financial returns. Overall, this debate over whether ESG integration violates fiduciary duty reflects the fact that there is no explicit principles on ways to integrate ESG in making investment decisions.

2.2. Lack of Standardized Frameworks and Inconsistencies in Data Reporting

The lack of consistent reporting standards for ESG data is a significant impediment to the adoption of sustainable investing methods [5]. According to Uuriintuya Batsaikhan and Louis Larue, there is no established legal definition of ESG in the European Union (EU), and no clear and enforceable legislative framework that ESG rating providers can use [6]. Although ESG provides a broad framework, created by the 2006 UN Principles for Responsible Investment, about how to integrate it into the process of sustainable investing, it does not provide specific standards. Thus, a variety of versions of ESG ratings, statistics, and indexes in various forms have emerged and developed dynamically. They are mostly created by large enterprises, as tools for self-beneficial purposes. This, according to Dimmelmeier, was followed by a quick concentration of the ESG industry into a small number of large companies [7]. These larger players in the market then utilized ESG as a tool to increase their market share, making it difficult for smaller firms to enter the market and compete. Although ESG at the time did acquire some sort of standards, these standards were established based on the preference of big firms to obtain private regulation of the market. Without an agreed-upon standard, ESG ratings involve huge inconsistencies in data reporting. Reportedly, there are more than 150 ESG rating providers around the globe [8]. A study analyzing and comparing the scores provided by six eminent ESG rating agencies discovered a significant difference between the key components of ESG ratings --- scope, measurement, and weightings, also known as "aggregate confusion" [9][10].

Moreover, according to another study, ESG suppliers purposefully changed the ratings of their own to the point where there were no identical scores between the two versions of the same dataset [11].

The situation of lacking an agreed-upon standard of ESG is called an "ESG ratings gap" [12]. According to an OECD study conducted recently, the "ESG ratings gap" demonstrated the large differences between ESG ratings and credit ratings of a company. While there are only minimal discrepancies between credit ratings, ESG ratings differ enormously. The existence of this huge ratings gap results in the lack of incentives for corporations to make an effort to improve their ESG ratings since credit ratings are more stable and convincing. Therefore, investors have no reason to trust ESG ratings, which prevents them from taking ESG into account when making investment decisions. According to a recent PwC survey, among all investors, only 40% trust the ratings provided by ESG rating agencies, and only 30% greatly rely on ESG ratings in investment decision-making [13]. This low faith in ESG credibility makes its integration difficult.

While there have been attempts to establish a standard for ESG ratings, like the EU taxonomy for sustainable activities, there are some major difficulties. First, as mentioned in previous paragraphs, ESG ratings today are mainly provided by large corporations, and these corporations set their own standards to increase market share and outperform others. Thus, setting an agreed-upon ESG rating standard would be difficult as it will harm those large corporations' interests. Second, there are a wide variety of companies, with some being more environmentally friendly than others. For instance, companies producing green materials are more environmentally friendly than those mining coals. Since ESG ratings highly value companies' performance on environmental protection, environmentally friendly firms will inevitably obtain a more advantageous position than those that are not environmentally friendly in ESG ratings. This potential unfairness makes it difficult for non-beneficiaries to accept the use of a standardized ESG rating system. Finally, it is hard to decide whether some environmental factors should be considered in ESG ratings. For example, there is a disagreement within the EU regarding the inclusion of gas and nuclear in ESG ratings.

2.3. The Unreliability of ESG Ratings

As environmental and social factors are of great importance in ESG considerations, according to Allred and Catherine M., ESG opportunities and risks are greatly influenced by societal trends with large-scale impacts [6], such as urbanization and climate change. First, urbanization involves inevitable harm to the environment. Building infrastructures often requires opening up new areas by using methods such as cutting down forests and reclaiming land from the sea. Companies responsible for these constructions will be discouraged if their ESG ratings are reduced for harming the environment due to their effort in urbanization, even though they are making great contributions to social development. The transition to a better economy can create new job opportunities, thus intensifying the competition for high-quality labor and requiring upskilling of the current workforce. Therefore, companies would have to invest more in acquiring a more skillful workforce to maintain their ESG ratings. Second, climate change poses risks such as rising sea levels, severe weather events, and wildfires that can directly affect a company's operation. These risks may lead to financial losses and business disruptions, underscoring the importance of climate related ESG metrics. There are other defects of ESG that affect its reliability. For example, the 2018 Final Report published by the EU High-Level Expert Group(HLEG) claims that most products with designations such as "SRI" (Socially Responsible Investment), "sustainable," and "ESG" are self-evaluated. According to the report, these products involve varying degrees of ambition, openness, and methodology in global marketplaces. This diversity may make ordinary investors less protected and affect how manufacturers compete [14].

2.4. Other Problems

Corruption exists in the ESG investment chain. A typical example is "greenwashing," where companies exaggerate or falsely claim their environmental or social responsibility to attract ESG investors. There have been numerous cases where companies have faced allegations of greenwashing.

A well-known example is the Volkswagen Diesel Scandal. According to report from the US Environmental Protection Agency (EPA), Volkswagen sold roughly 590,000 diesel motor cars with computer software meant to pass federal emissions tests, which violated the Clean Air Act between model years 2009 and 2016 [15]. The famous fast fashion retailer H&M has also been criticized for promoting its sustainability efforts while facing allegations of unethical labor practices and overproduction of clothing. If greenwashing practices become prevailing, taking into account ESG in investment decision-making would be meaningless.

Another problem of ESG that has made it controversial is that ESG integration can be burdensome. Emiel van Duuren et al. claimed that ESG integration potentially places an extra burden on investors during the process of investment decision-making and imposes costly constraints [16]. According to Kempf and Osthof's research, mutual funds that invest in ESG have higher expense ratios [17]. The average difference in their study was 13 basis points, which was a great difference statistically.

Finally, one of the most significant issues is the absence of a common framework for the E, S, and G parts, which often produces inconsistencies even within one single ESG report. Consider a company that originally produces fossil-fueled vehicles turns to produce electric vehicles to earn a higher ESG rating to attract investors. This will result in a lowered carbon footprint in the company's ESG reports, thus increasing its ESG rating. However, if this transformation to electric vehicle production actually leads to a higher usage of harmful materials, such as the enormous amount of tin and lithium used in the production of batteries, an essential part of an electric vehicle, the ESG rating will not be affected.

Similarly, if a company is criticized for the high incidence of workplace incidents indicated in its ESG report, it may dismiss the majority of workers and replace them with automatic techniques. As the company's incidence of workplace incidents decreases due to the heavily reduced number of workers, its ESG rating will rise. However, the ESG rating does not take into account the large unemployment caused by the company's action and the potential consequences it brings. As a result, the absence of a common framework for the "E," "S," and "G" elements in ESG ratings makes them more unreliable.

3. Potential Solutions and Recommendations

Integrating ESG factors into investment decision-making is a challenging task. However, there are several potential solutions and suggestions for the future development of ESG in investment.

3.1. Standardization and Reporting

The lack of standardized data reporting practices is an important problem that prevents ESG integration into investment decision-making. To address this issue, it is essential to establish globally recognized ESG reporting standards. The new standard should include a clear reporting procedure, which is transparent to both companies and investors, which clarifies every single factor that should be considered in each of the "E," "S," and "G" components. The new standard should also be more comprehensive by taking into account the potential impacts, such as the consequences of unemployment mentioned before, but not only the ones on the surface. A great example of such an impact-included accounting system would be the E-liability system. While ESG tends to overly focus on financial performances, the E-liability system allows for a distinct materiality standard for environmental reporting that is entirely independent of materiality considerations for financial reporting and is based on the quantity of greenhouse gas (GHG) emissions. Currently, major ESG reporting standards require businesses to disclose any environmental factors that may put them at financial risk. This enables many GHG-intensive practices that have no discernible effect on a company's financial statements to go unreported. In contrast, the E-liability system employs a materiality standard that is irrespective of short-term or long-term financial implications and is based on the size of E-liabilities that are acquired, generated, and transferred. Only if the new ESG standard fully considers each of the "E," "S," and "G" elements can its ratings become more reliable, and its

integration be more effective. That is when investors really begin to invest for a better planet, not merely for profits.

3.2. Transparency and Regulatory Framework

The lack of transparency is a big defect of ESG, and it is aggravated by the absence of regulation. According to an inquiry by the European Commission (EC), none of the ESG rating providers involved in the inquiry explicitly described the regulatory framework they used in the rating process. Some of the providers even did not follow any framework [19]. Since effective ESG integration depends on transparent, high-quality ESG data, companies should be encouraged to disclose comprehensive and pertinent data in order to increase the credibility of ESG information. Implementing regulations that mandate ESG disclosures and third-party verification procedures is a strong recommendation. The current regulations on ESG are weak. For example, some EU countries are not imposing disclosure obligations on ESG rating agencies, though they are imposed on corporations and investors, and there is little consistency among countries [18]. While there is an increasing demand for regulations, a 2022 consultation conducted by the EC found that a majority of respondents recognized that the market may be affected by potential conflicts of interest under regulations [19]. Thus, to foster an innovative and competitive market for ESG rating data, the regulation of ESG needs to be adjusted to the size and market relevance of ESG rating providers. There are already examples of proposals for regulations of ESG. The EC has urged greater disclosure by businesses and asset managers, as well as increased transparency regarding the underlying methodologies used in ESG ratings [18]. At the same time, the European Central Bank (ECB) has also released proposals for increased transparency [20].

3.3. Education and Awareness

ESG principles must be widely understood and known in order to be successfully incorporated into investment practices. To achieve this, efforts should be made to raise awareness of the importance of ESG factors among investors, financial experts, and the general public. The inclusion of ESG topics in the Chartered Financial Analyst (CFA) curriculum by the CFA Institute is a noteworthy initiative.

Encouraging investors to adopt a long-term perspective is another essential measure for effective ESG integration. Short-term-oriented investors may ignore the long-term sustainability advantages of ESG-conscious investments. It is advisable to put policies in place that discourage short-term trading and promote long-term holding periods in order to reward a longer-term outlook.

4. Conclusion

There are serious problems with ESG that prevent its integration into investment decision-making. The four major problems identified in this essay are: the perceived violation of fiduciary duty, the absence of standardized frameworks and inconsistencies in data reporting, the unreliability of ESG ratings, and the lack of a common framework. In addressing these challenges, some suggested solutions include standardizing ESG and its reporting procedures, developing a regulatory framework to increase transparency, and educating investors and the public about ESG integration and its benefits. This essay is expected to serve as a resource for investors seeking to overcome the barriers to ESG integration and foster a better understanding of the challenges and solutions within the ESG system. At the same time, this essay calls on decision-makers and business leaders to take proactive measures to create a more sustainable and ethical investment environment.

However, the rapidly evolving sustainable investment and ESG system mean that the challenges and potential solutions outlined in this essay may require regular updates to remain relevant. In addition, the effectiveness of the solutions proposed in this essay may vary across different regions and sectors, requiring further in-depth analysis.

In general, the investigation in this essay into ESG integration challenges and potential solutions highlights the critical need for a joint effort by all stakeholders to promote responsible and sustainable investment practices. Moving forward, more research and collaboration will be needed to overcome these obstacles and realize the full potential of ESG integration in investment decision-making.

References

[1] Kaplan, R. S., & Ramanna, K. (2021). How to fix ESG reporting. *Harvard Business School Accounting & Management Unit Working Paper,* (22-005).

[2] Sandberg, J. (2011). Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective. *Journal of Business Ethics, 101*(1), 146. http://www.jstor.org/stable/41475890

[3] Langbein, J. H. and R. A. Posner. (1980). Social Investing and the Law of Trusts'. *Michigan Law Review* 79(1), 72-112.

[4] Moliterni, F. (2018). *Sustainable Investing and Green Finance: Boosting markets by solving* am biguities (S. Pareglio, Ed.). Fondazione Eni Enrico Mattei (FEEM), 3. http://www.jstor.org/stable/resrep16403

[5] Allred, Catherine M. (n.d.). *Environmental, Social, and Governance (ESG) Investing: From Scarlet to Green.* https://jstor.org/stable/community.29406029

[6] BATSAIKHAN, U., LARUE, L., & EUROPE, P. M. (2023). HOW TO STOP THE WILD GREEN GOLD RUSH: CREDIBLE ESG RATINGS.

[7] Dimmelmeier, A. (2020). Mergers and Acquisitions of ESG Firms: Towards a New Financial Infrastructure? SocArXiv. doi:10.31235/osf.io/jt2uk

[8] Pollmann, E. (2022). *The Origins and Consequences of the ESG Moniker.* Institute of Law and Economics Research Paper No. 22-23. https://ecgi.global/sites/default/files/Paper%3A%20Elizabeth%20Pollman.pdf

[9] Berg, F., Kölbel, J., and Rigobon, R. (2022). *Aggregate Confusion: The Divergence of ESG Ratings. Review of Finance.* https://doi.org/10.1093/rof/rfac033

[10] Billio, M., Costola, M., Hristova, I., Latino, C., and Pelizzon, L. (2020). Inside the ESG Rating s: (Dis) Agreement and Performance. SAFE Working Paper No. 284. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3659271

[11] Berg, F., Fabisik, K., and Sautner, Z. (2020). Rewriting History II: The (UN) predictable past of ESG ratings. *European Corporate Governance Institute,* ECGI Working Paper No. 708/2020. https://ecgi.global/sites/default/files/working_papers/documents/bergfabisiksautnerfinal.pdf

[12] Fichtner, J., Jaspert, R., & Petry, J. (2023). GOVERNANCE AND ESG. In *MIND THE ESG GAPS:* TRANSMISSION *MECHANISMS AND THE GOVERNANCE OF AND BY SUSTAINABLE* FINANCE (pp. 7–14). Danish Institute for International Studies. http://www.jstor.org/stable/resrep48454.5

[13] PwC (2021). 2021 Global investor survey. https://www.pwc.com/gx/en/services/audit-assurance/corporate-reporting/2021-esg-investor-survey.html EU. (2018). The EU in 2018.

[14] EPA. (2022). Learn About Volkswagen Violations. https://www.epa.gov/vw/learn-about-volkswagen-violations

[15] van Duuren, E., Plantinga, A., & Scholtens, B. (2016). ESG Integration and the Investment Management Process: Fundamental Investing Reinvented. *Journal of Business Ethics, 138*(3), 525–533. http://www.jstor.org/stable/44164180

[16] [Kempf, A., & Osthoff, P. (2008). SRI Funds, Nomen est Omen. *Journal of Business, Finance & Accounting,* 35, 1276-1294.

[17] EC. (2022). "Targeted Consultation on the Functioning of the ESG Ratings Market in the European Union and on the Consideration of ESG Factors in Credit Ratings." Brussels: European Commission. https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2022-esg-ratings_en.

[18] EC. (2020). "Study on Sustainability-Related Ratings, Data and Research." Brussels: European C ommission. https://op.europa.eu/en/publication-detail/-/publication/d7d85036-509c-11eb-b59f-01aa75ed71a1/language-en.

[19] Breitenstein, Miriam, Stefania Ciummo, and Florian Walsh. (2022). "Disclosure of Climate Change Risk in Credit Ratings." ECB Occasional Paper Series n°303. Frankfurt am Main: European Central Bank. https://www.ecb.europa.eu/pub/pdf/scops/ecb.op303~eaa6fe6583.en.pdf.