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INTEGRATION OF ESG INVESTMENTS: EXAMININGTRENDS &GAPS

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Abstract:
The research paper aims to shed light on the nature, purpose, and the future of ESG investing. The objective of the study is to examine existing rules, regulations, and guidelines at the global level; identify gaps in the existing regulatory frameworks in India; and suggest measures for sustainable ESG investing in India. It is an exploratory and descriptive study based on the analysis of various reports on ESG investing published by the Big Four consulting firms. The study involves structured analysis, comparison, and integration strategies suggested by the Big Four regarding ESG investing, with recommendations provided. Environmental criteria assess a company's carbon footprint, resource utilisation, and commitment to sustainability. Social criteria evaluate labour relations, diversity, community welfare, and human rights. The study also includes the significance of ESG investing, challenges, evolution and trends, blending ESG and investment strategies, and the discernible outlook of investing in ESG. While countering challenges in formulating regulations by the Government and the Regulators - impetus, innovation, and enhanced expectations for transparent and ethical investing positions ESG as a formidable strength shaping the future of investment strategies. The study provides recommendations on how ESG investing can boost sustainable and responsible investment practices in India.
Keywords*: ESG Investing, Sustainability, Environmental, Social, Governance, Trends, Gaps*

Introduction:

The Ministry of Corporate Affairs issued Corporate Social Responsibility (CSR) guidelines in 2009, which could be considered as the origin of ESG in India. The term ESG investing itself is subjective as it is not well-defined anywhere. The absence of uniform government guidelines and limitation of rules and regulations leave the choice of ESG compliance to the companies. Even then, in recent years, ESG investing has been steadily gaining popularity, indicating a transformation approach to the way trusts and investment fiduciaries assess companies before making investment decisions. Such a transformation envisages a company's inclination towards the environment, its societal responsibilities, and the efficiency of its governance structure. ESG investing considers non-financial factors in investment decisions, signifying a paradigm shift in the investment landscape, focusing on sustainability, social responsibility, and efficient governance apart from rewards.

Problem Statement:

How do varying ESG regulatory frameworks across different regions affect the consistency and effectiveness of ESG investment strategies apart from bringing out gaps in Indian context?

Objectives of Study:

- To compare the findings from Big Four reports on ESG investing globally apart fromunderstanding major themes
- To examine extant rules, regulations, and guidelines globally.
- To identify gaps in the existing regulatory frameworks in India.
- To provide recommendations for improvement to promote sustainable and responsible investment practices in India.

Methodology:

The methodology is an exploratory and descriptive study of the trends and gaps in the regulatory framework on ESG investing. Based on the reports published by Big Four consulting firms, namely, Deloitte, Ernst & Young (EY), KPMG, PwC–the study carries out an analysis of ESG investing strategies like understanding, significance,challenges, integration, trends, and future outlook.The big four reports and research papers in literature review accessed in January 2024 and July 2024, respectively. The research study analyses rules and regulations in US, Europe, and India for comparison purposes. It also identifies existing gap in rules, regulations, and the guidelines issued in

India on ESG investing, apart from recommendations for improvement. Additionally, it includes discussion with financial experts on various aspects of ESG investing.

Literature Review

Recent studies highlight the increasing integration of Environmental, Social, and Governance (ESG) criteria into investment practices, driven by both regulatory developments and investor demand. Clark and Hebb (2018) discuss how institutional investors are redefining corporate social responsibility (CSR), emphasizing ESG factors as integral to sustainable investment strategies. They argue that despite progress, inconsistencies in ESG reporting standards persist, hindering comparability across firms and regions (Clark & Hebb, 2018).

Eccles, Ioannou, and Serafeim (2014) explore the impact of corporate sustainability practices on organizational processes and financial performance. They find that robust ESG initiatives can enhance long-term value creation but note challenges in measuring and reporting non-financial performance metrics, which can undermine investor confidence (Eccles et al., 2014).

Oikonomou, Brooks, and Pavelin (2012) provide insights into the financial implications of corporate social performance, suggesting that firms with strong ESG practices may experience lower financial risk and attract long-term investors seeking sustainable returns (Oikonomou et al., 2012). However, they caution that the lack of standardized ESG disclosure frameworks complicates the assessment of ESG impacts on financial outcomes.

Scholtens and Sievänen (2013) examine the drivers of socially responsible investing (SRI) in Nordic countries, identifying regulatory frameworks and investor preferences as key factors shaping ESG integration. They emphasize the need for clear guidelines and consistent metrics to facilitate informed investment decisions aligned with sustainability goals (Scholtens &Sievänen, 2013).

Overall, while ESG integration has gained traction, gaps in rules, regulations, and guidelines remain significant challenges. Harmonizing ESG reporting standards and enhancing transparency are critical to fostering trust among investors and realizing the full potential of sustainable investing practices.

Analysis of Big Four Reports

1. ESG investing considers non-financial factors in investment decisions. Environmental criteria assess a company's carbon footprint, resource utilisation, and commitment to sustainability. Social criteria evaluate labour relations, diversity, community welfare, and human rights. Governance factors emphasize the company's leadership, board structure, executive remuneration, and internal monitoring.

Table I – Understanding ESG Investing

Parameter	Deloitte	Ernst & Young	KPMG	PwC
Institutional Prioritization	While institutional investors prioritize ESG, just 23 percent fully integrate ESG principles; 30 percent segregate ESG and investment functions	Investment houses prioritize ESG integration strategically, whether culturally ingrained over years or rapidly up-skilled	Hedge fund managers progress in ESG beyond governance due to institutional investor influence	ESG's influence on investment strategies grows, expected to increase further. Investors demand ESG disclosures to assess performance
Integration Levels		Despite unanimous acknowledgment of ESG's importance, integration levels in firms' strategies and product offerings vary significantly		
Specific Expectations			Hedge fund managers expected to exclude specific activities and actively pursue positive ESG outcomes alongside financial goals	Investors expect robust, data-driven analysis for ESG investment decisions. Rising interest in sustainability issues like 'just transition' to low-carbon economy
Driving Forces			Main driving force behind hedge fund ESG progress is institutional investors and consultants	
Investor Demands				Investor and stakeholder insistence on ESG information disclosures to benchmark performance
Sustainability Concerns				Rising interest in tackling sustainability issues, including 'just transition' to low-carbon economy

2. ESG investing establishes a linkage between investor values and financial goals. Besides investment returns, it brings about positive change, encouraging companies to embrace sustainable practices and social responsibility. Market studies reflect that companies with considerable ESG

focus tend to depict lower risk profiles and the potential for good long-term returns, thereby attracting socially conscious investors and institutional funds.

Table II - Significance of ESG Investing

Parameter	Deloitte	Ernst & Young	KPMG	PwC
Sustainable Investing Assets	Europe leads with US$14.1 trillion, followed by the USA with US$12 trillion in sustainable investing assets			
Global Growth Factors	Significant global growth in ESG sector due to increased investor interest in the USA	Institutional investors drive ESG demand, serving as catalysts for solution development	Conventional risk-return framework evolving to include ESG factors; addressing environmental and social challenges integral to sustainable investment outcomes	Majority of US investors prioritize ESG over short-term profitability; expect no adverse long-term impact on investment returns from ESG investments
Integration of ESG Principles	Retail and institutional investors integrating ESG principles into at least 25% of portfolios surged from 48% to 75% from 2017 to 2019	Growing pressure on asset managers to execute UN PRI; demand for transparency in ESG integration efforts		
Investor Preferences		Increasing demand for transparency in ESG integration; desire for enhanced assistance from fund managers in education, ideation, and thought leadership	Recognition of ESG factors' impact on investment returns; shift towards sustainable investment outcomes	
Short-term vs. Long-term				Majority of US investors willing to forego short-term profitability for ESG, expecting no long-term adverse impact on returns

3. Despite its rapid transformation, ESG investing encounters many challenges. It’s difficult to measure and differentiate ESG performance across companies owing to unavailability of uniform metrics and disclosure structures. “Greenwashing,” where companies inflate their ESG efforts, poses a question mark on credibility. In addition, balancing financial returns with ESG goals is a continuous concern for some investors.

Table III - Challenges in ESG Investing

Parameter	**Deloitte**	**Ernst & Young**	**KPMG**	**PwC**
ESG Disclosures' Transparency	Transparency and reliability of ESG disclosures raise ongoing concerns	Push for enhanced transparency in ESG reporting driven by institutional and high-net-worth retail clients	Challenges in quantifying foundational ESG concepts like materiality and intentionality	US investors expect companies to clarify significance and impact of ESG issues on operations
Standardized Framework	Investors grapple with absence of standardized framework guiding ESG principles	Asset and wealth managers lack formal ESG education programs for advisors	Evaluating materiality and intentionality of ESG factors for financial performance poses challenges	Inconsistent receipt of necessary ESG information noted by US investors
Definitions of ESG Factors	Anticipated enhancement of efficiency and meaningful engagement through consistent definitions for environmental, social, and governance factors	Disparity in reporting ESG metrics among respondents	Objective is to yield societal benefits alongside financial returns; learning-by-doing approach to address ESG complexities	Deficiencies in understanding importance of ESG factors in company business models highlighted by US investors
Challenges in ESG Integration			Blend of data and subjective judgment required to address ESG complexities; steep learning curve remains.	

4. Investors adopt different approaches to align ESG factors into their investment strategies. These include evaluation, where investors might exclude certain industries or companies, based on proactive methods like impact investing and thematic investing.

Table IV - Integration of ESG into Investment Strategies

Parameter	Deloitte	Ernst & Young	KPMG	PwC
ESG Metrics and Alpha Generation	Recent research indicates ESG metrics could potentially contribute to generating alpha	Most asset managers anticipate 2 to 5 years for complete ESG integration into investment strategies	Asset managers should explain implementation methods at fund or mandate level: investment policy articulation, international standards alignment, data sources utilization, real-time tracking mechanisms, definitional templates used, corporate engagement policies, resources allocated to engagement practices and their results	US investors advocate for holding CXOs accountable for ESG, suggesting management compensation tied to sustainable practices. Majority support ESG integration into company strategy, but 22% oppose it
Client Demands	ESG presents an opportunity to meet client demands while enhancing returns		Investors prioritize clear connection between sustainability policy and practical impacts	
Implementation Strategies	Back-testing on ESG metrics shows strategy dependent on these parameters can surpass global stock combinations			Doubts expressed about directors' familiarity with ESG matters; calls for detailed explanations of ESG integration into strategy and its tangible impact
Management Accountability				Advocacy for CXO-level accountability for ESG; management compensation seen as incentivizing sustainable practices

5. ESG investing continues to evolve with innovations in data analytics, machine learning, and artificial intelligence. Standardized reporting frameworks such as“Global Reporting Initiative” (GRI) and the “Sustainability Accounting Standards Board” (SASB) have emerged to facilitate the

development of consistent reporting practices aims to enhance transparency and comparability. Furthermore, regulatory bodies worldwide are increasingly emphasizing ESG disclosure requirements, influencing investment decisions.

Table V - Trends in ESG Investing

Parameter	Deloitte	Ernst & Young	KPMG	PwC
Portfolio Differentiation	Portfolio managers increasingly adopt ESG; differentiation becomes essential	Demand rising; future clients may prioritize impact as much as performance	Direct engagement with investee companies effective for influencing behaviours; divestment as last resort if efforts fail	Momentum towards standardized ESG reporting expected to increase in 2023. International Sustainability Standards Board (ISSB) progressing with International Standards for sustainability reporting. Governments propose climate-related financial disclosure framework for corporates and financial institutions
ESG Product Innovation	Trajectory of ESG product innovation pivoting towards customization		Engagement grounded in belief that entities contributing to problem can contribute to solution; lengthy and intensive process	
Tailored ESG Products	68% of fund managers predict substantial expansion in ESG investments from tailored products		Asset managers may resort to divestment as last resort if other engagement efforts fail	
Standardized ESG Reporting				ISSB making progress on International Standards for sustainability reporting; governments propose compulsory sustainability and ESG reporting requirements for large corporates from 2024

6. ESG investing looks promising as it is becoming mainstream. Collaboration among investors, regulators, corporations, and self-regulatory bodies is critical to set robust regulations and metrics. Technology will play a crucial role in enriching data analysis and ESG integration. Additionally, as societal awareness and demands for corporate social responsibility grow, ESG considerations are expected to tilt towards investment decision-making.

Table VI - Future Outlook of ESG Investing

Parameter	Deloitte	Ernst & Young	KPMG	PwC
Confidence in Sustainable Investing	89% of fund managers confident sustainable investing will remain prominent; firms planning to allocate more resources to this field		Standards for ESG best practices evolving; expectation for investments to actively create positive ESG impacts	Commitment to ESG initiatives enhances resilience and increases long-term valuation. Investors need rationale and timeframe for ESG investments' positive outcomes
Strategies and Teams		Asset managers forming ESG-dedicated teams; developing own ESG scoring methodologies and alpha generation strategies		
Data Integration and Reporting		Collaborating on data sourcing and integration into systems; creating specialized ESG reporting systems.		
Expectations for Hedge Funds			Hedge funds expected to deliver non-financial outcomes alongside strong financial returns; heightened scrutiny on ESG practices	

Additionally, financial experts, including analysts, bankers, chartered accountants, and mutual fund distributors, were interviewed or responses sought to a questionnaire addressing various aspects of ESG investing to gather their perspectives. According to them, the universe in India is very small, and the returns generated are not in line with the expectations of retail investors. Investment fiduciaries consider investing in ESG-compliant corporate or MF schemes, but individual investors, barring HNIs and ESG-sensitive investors, are averse to investing in ESG funds. An Analyst pointed out the exclusion of companies which have low ESG scores and inclusion of best-in-class companies having high ESG scores. ESG-compliant schemes' objective is to reduce risk and volatility, apart from focusing on Stakeholder's capitalism and prioritizing sustainability. Some of them suggested more disclosure on different ESG parameters for corporate and MF schemes, leading to awareness among retail investors.

A comparative analysis of ESG regulations across select regions becomes imperative to identify trends, gaps, and policy opportunities, enriching research by providing a global perspective on the evolving field of ESG investments.

Table VII - Comparative Analysis of the rules and regulations in US, Europe, and India

Aspect/Category	United States	Europe	India
Regulatory Body	SEC (Securities and Exchange Commission), DOL (Department of Labor), State regulations	EU Commission, ESMA (European Securities and Markets Authority), National regulators	SEBI (Securities and Exchange Board of India), RBI (Reserve Bank of India)
Mandatory Reporting	SEC's Disclosure Requirements, DOL Guidelines for ERISA Plans	EU Non-Financial Reporting Directive, TCFD (Task Force on Climate-related Financial Disclosures) recommendations	SEBI's Stewardship Code, BSE's Listing Obligations and Disclosure Requirement
Fiduciary Duties	Growing emphasis on ESG integration, DOL's Interpretive Bulletin 2015-01	EU Sustainable Finance Disclosure Regulation (SFDR), MiFID II	SEBI's stewardship responsibilities for institutional investors, fiduciary duties under company law
Tax Incentives	Limited federal incentives, potential state-level incentives	Taxonomy Regulation providing incentives for sustainable investments	Tax benefits under CSR (Corporate Social Responsibility) spending
ESG Disclosure Standards	No uniform standards, voluntary frameworks like SASB, GRI, TCFD	Harmonization efforts under SFDR, TCFD recommendations, EU Taxonomy	SEBI's Business Responsibility and Sustainability Reporting (BRSR) framework
Investor Activism	Increasing shareholder proposals, proxy voting guidelines	Shareholder Rights Directive II (SRD II) enhancing shareholder engagement	Shareholder activism growing, but less structured compared to the West
Emerging Trends	Rise of impact investing and shareholder resolutions	Green finance initiatives and sustainable bonds market	Green bonds and sustainable finance initiatives

The table VII highlights the varying approaches and regulatory landscapes concerning ESG investing in the US, Europe, and India, reflecting global efforts to integrate sustainability into financial markets.

Gaps in Rules, Regulations, and Guidelines in India

On perusal of Table VII, despite the growing conviction in Environmental, Social, and Governance (ESG) investing in India, there exist some gaps in rules, regulations, and guidelines governing this field that is steadily gaining traction:

- India lacks a standardized and mandatory framework for ESG reporting, unlike the US and Europe.
- Insufficient clarity and guidance on ESG integration across sectors lead to inconsistent practices in India.

- India's investor protection mechanisms for ESG investing are relatively limited compared to Europe.
- Despite existing tax incentives, India needs broader fiscal policies to accelerate ESG adoption among companies

Addressing these gaps is crucial to boost sustainable and responsible investment practices in India. However, India has become the first among other countries in the world where ESG disclosures are standardized, ESG rating providers are regulated, and reasonable mandates are assured. SEBI has adopted a phased approach for the implementation of Business Responsibility and Sustainability Report (BRSR) having core key performance indicators. The recommended timelines for listed entities, categorized by market capitalization, as per the SEBI circular dated July 12, 2023, are provided in the table below:

Table VIII – Market Capitalisation ranking-wise Coverage of Listed Entities in India and Effective date

Market Capitalisation of Corporate	Effective date
From 1 - 150 corporates	March 31, 2024
From 151 - 250 corporates	March 31, 2025
From 251 - 500 corporates	March 31, 2026
From 501 - 1000 corporates	March 31, 2027

Conclusion

The study underscores the evolving landscape of ESG investing in India, marked by significant regulatory gaps despite recent strides. The absence of a standardized ESG reporting framework and clear guidelines for integration across sectors in India contrasts with more developed regimes in the US and Europe.

Asset managers recognize the imperative of integrating ESG into the investment process for their survival, but approaches to this integration vary across organizations with different propositions, strategies, and methods. Companies provide the primary sources of ESG information to investors, thereby improving percolation of how ESG is "integrated into the company's strategy" and its value proposition could lead to a big impact.The majority of US investors are integrating ESG into their analyses, prompting companies to adjust their strategies to meet investor expectations.

An emerging ecosystem of customized "ESG products and platforms" offers fund managers chances to enhance their value proposition to clients. There is an increasing realization that finance must give something back to society while making a profit. The future growth in "ESG investing" might not be driven by excluding "sin" stocks but could instead be propelled by managers using "high-quality ESG data" to generate an alpha.

While SEBI's phased implementation of the Business Responsibility and Sustainability Reporting (BRSR) framework represents a step forward, broader fiscal incentives and enhanced investor protection mechanisms are imperative to foster sustainable investment practices effectively. The findings highlight the critical need for comprehensive regulatory reforms to align with global standards, ensuring consistency, transparency, and investor confidence in ESG initiatives across Indian markets.

Meanwhile, SEBIhave approved CRISIL ESG Ratings & Analytics Ltd as a Category I ESGratings provider. There could not have been a better time when corporate are enhancing ESG disclosures and financial markets are becoming conducive to independent ESG ratings.

Table IX - ESG funds' average total return is compared with that of other non-ESG fund categories and the Nifty 500

ESG Funds	Large-cap	Mid-cap	Small-cap	Multi-cap	Nifty 500
13.28%	**13.83%**	**18.25%**	**25.78%**	**19.49%**	**15.67%**

(Data Source: CRISIL Market Intelligence & Analytics Report 2022)

ESG funds have underperformed compared to most of their non-ESG funds. This could stem from the lack of a comprehensive track record, a significant allocation to large-cap companies, and the avoidance of small- and mid-cap companies that potentially generate high returns due to non-ESG compliance, BRSR might resolve issues like data availability, andretail investors not seeing ESG-aligned funds meeting return goals.

Recommendations

Fostering ESG investing on a sustainable basis in India requires coordinated efforts from regulatory bodies, market participants, and stakeholders.

- Develop a standardized and mandatory ESG reporting framework aligned with global standards to enhance comparability and transparency.
- Provide clearer guidance on ESG integration across sectors to ensure consistent practices.
- Strengthen fiduciary duties for institutional investors regarding ESG factors to build investor trust.
- Introduce broader fiscal incentives and policies to accelerate ESG adoption among corporations and investment fiduciaries in India.
- It is essential to educate investors and investment fiduciaries about the long-term benefits of integrating ESG factors into investment strategies to facilitate mainstream adoption.
- Finally, promoting collaboration among government, businesses, and civil society for ESG investing can drive innovation and collective action towards achieving relevant sustainable development goals (SDG) in India.

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