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A STUDY ON ESG ECONOMIC REALITIES AND INVESTORS' PERSPECTIVES WITH SPECIAL REFERENCE TO THE INDIAN STOCK MARKET

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Abstract

Environmental, Social, and Governance (ESG) investing has emerged as a significant paradigm in financial markets worldwide. In India, ESG considerations are gaining traction among investors due to regulatory mandates, increasing corporate accountability, and shifting societal expectations. This study examines the economic realities of ESG in the Indian stock market and explores investor perspectives on ESG investment strategies. The research highlights key challenges, opportunities, and future trends shaping ESG investing in India.

INTRODUCTION

With growing global awareness about sustainable finance, ESG principles have become critical for evaluating corporate performance beyond traditional financial metrics. The Indian stock market, influenced by regulatory frameworks and investor sentiment, has witnessed a surge in ESG-related investments. This paper aims to analyze the economic impact of ESG investing and understand investor perceptions regarding its effectiveness in generating financial returns while promoting sustainability.

In light of global challenges such as climate change, COVID-19, and international conflicts, the emphasis on protecting the environment and respecting people's interests is driving significant social transformations (Garel & Petit-Romec, 2021; Nordhaus, 2019). Companies are increasingly exploring ways to operate with greater ethical responsibility and sustainability, and the integration of environmental, social, and governance (ESG) principles has become a key focus in capital markets. As the world's largest manufacturing nation, China faces a particularly stark tension between environmental pollution and economic growth in the global marketplace. The 2018 Environmental Performance Index, published by Yale University, ranked China 177th out of 180 countries in terms of air quality, underscoring the critical and long-term challenge of balancing pollution control with sustainable development. In response, the Chinese government has made a formal commitment to peak carbon dioxide emissions by 2030 and achieve carbon neutrality by 2060. Historically, China's market has been more focused on financial performance, with less emphasis on environmental and social responsibilities. Additionally, regulatory frameworks did not mandate the disclosure of non-financial social responsibility information, as pressure from market competition and non-governmental organizations was relatively weaker compared to other nations (Ong & Han, 2019). However, the ongoing transformation of China's economy demands that companies take on greater environmental and social responsibilities, resulting in heightened attention to the ESG disclosures of Chinese firms across all sectors of society.

Before examining the link between ESG disclosure, ESG investors, and financial performance, three issues must be addressed. First, how to effectively identify corporate ESG information disclosure. Previous studies have relied on ESG scores or ratings from authoritative agencies to measure companies' ESG performance (Atif & Ali, 2021; Baker, Boulton, Braga-Alves, & Morey, 2021; Garel & Petit-Romec, 2021; Joliet & Titova, 2018). However, this method has two key limitations. First, there is no universal rating standard or regulatory framework (Avramov, Cheng, Lioui, & Tarelli, 2022; Pedersen, Fitzgibbons, & Pomorski, 2021; Serafeim & Yoon, 2022). Different rating agencies may assign differing ESG scores to the same company, leading to potentially biased conclusions (Clementino & Perkins, 2021; Friede, 2019). Second, companies may engage in strategic behavior, such as bribing rating agencies or "greenwashing," to manipulate ESG scores, which ultimately harms their long-term value (Avetisyan & Hockerts, 2017). The second issue is the endogeneity caused by reverse causality between ESG disclosure and financial performance. More developed companies may be more capable of taking on environmental and social responsibilities, which increases their willingness to disclose ESG information. The third issue is how to distinguish between investors with ESG preferences and general investors.

To address these issues, this study matches the financial data of Chinese listed companies and fund data from 2000 to 2020, using Bloomberg's first ESG rating announcement as a natural experiment. A staggered difference-in-differences (DID) model is employed to mitigate endogeneity caused by reverse causality. The results demonstrate that ESG disclosure significantly improves corporate financial performance. Robustness tests, including parallel trend tests, Goodman-Bacon decomposition, system GMM estimation, replacement of explanatory variables, and placebo tests, confirm the validity of these findings. The positive impact of ESG disclosure on financial performance is more pronounced for companies with ESG investors, as well as those with longer operating histories, higher media attention, and greater agency costs. Furthermore, the study shows that ESG investors have a positive moderating effect. The greater the shareholding ratio or market value of ESG investors, the stronger the impact of ESG disclosure on financial performance. Additional analysis reveals how ESG disclosure influences investors with diverse preferences. The study also examines the relationship between ESG ratings, ESG investors, and financial performance.

This study makes three key contributions. First, it investigates the relationship between ESG disclosures and corporate financial performance, contributing to the literature on informal disclosure practices and firm performance. It provides new empirical evidence on the integration of ESG principles in emerging markets, offering a model for other developing countries to follow. Despite the low level of institutional investor influence in China's financial market, the positive moderating role of ESG investors is significant. This finding suggests that both China and other developing nations should work to increase institutional investor participation and encourage a focus on ESG. Second, to avoid controversies around ESG rating criteria (Avramov, Cheng, Lioui, & Tarelli, 2022; Clementino & Perkins, 2021; Friede, 2019; Pedersen, Fitzgibbons, & Pomorski, 2021; Serafeim & Yoon, 2022) and to address reverse causality, we employ an event-study approach to infer the impact of corporate ESG disclosure on financial performance. Our analysis avoids the measurement errors typically associated with ESG ratings and effectively addresses endogeneity. Third, we construct a new dataset on ESG investors, derived from public reports of Chinese listed securities investment funds. Unlike prior studies that use weighted averages of ESG scores to categorize investor preferences (Cao, Titman, Zhan, & Zhang, 2020; Hwang, Titman, & Wang, 2021), we utilize the investment horizons and objectives disclosed by funds to differentiate between ESG investors and others. Our data set offers valuable insights into corporate ESG behavior and the preferences of specific investors.

The structure of this paper is as follows. Section 2 develops research hypotheses based on existing literature. Section 3 presents the model, key variables, and data sources. Section 4 reports the baseline results and conducts several robustness tests on the relationship between ESG disclosure and financial performance. Section 5 explores the heterogeneous effects of ESG disclosures on financial performance. Section 6 examines the moderating effect of ESG investors. Section 7 provides further analysis, and Section 8 concludes.

ESG Economic Realities in India

1. Growth and Adoption of ESG Investing

ESG investing in India has seen exponential growth, driven by:

- Regulatory requirements set by SEBI (Securities and Exchange Board of India)
- Mandatory ESG disclosures for top-listed companies
- Institutional investor preferences for sustainable investment portfolios
- Rising awareness among retail investors

Over recent years, Environmental, Social, and Governance (ESG) investing has gained significant traction, driven by growing awareness of sustainability and the increasing importance of corporate responsibility. Investors are now prioritizing companies that demonstrate strong ESG practices, seeking not only financial returns but also positive societal and environmental impacts. This shift reflects broader societal concerns about climate change, social equity, and corporate transparency.

The adoption of ESG investing is supported by a combination of factors, including enhanced regulatory frameworks, increased availability of ESG-related data, and growing demand from both institutional and retail investors. Governments and regulatory bodies worldwide have introduced guidelines and frameworks encouraging companies to disclose ESG-related information, making it easier for investors to make informed decisions.

The continued growth of ESG investing reflects a broader trend toward sustainability in the financial sector. As companies continue to adopt ESG principles and investors increasingly demand transparency, ESG investing is likely to remain a key driver of change in global financial markets.

2. Performance of ESG Funds vs. Traditional Funds

ESG funds in India have demonstrated competitive financial performance compared to conventional funds. Several studies indicate that companies with strong ESG practices exhibit lower risk, enhanced operational efficiency, and resilience during market downturns. However, challenges such as greenwashing and inconsistent ESG reporting remain significant concerns.

The performance of ESG funds compared to traditional funds has been a topic of growing interest among investors and researchers alike. ESG funds, which focus on companies with strong environmental, social, and governance practices, are often viewed through the lens of both financial returns and societal impact. Over the years, there has been a debate regarding whether ESG funds can outperform or underperform traditional funds, which typically prioritize financial performance without factoring in ESG criteria.

Recent studies and market data suggest that ESG funds have shown competitive returns relative to traditional funds. In many cases, ESG investments have demonstrated resilience, particularly during periods of market

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volatility, driven by their focus on sustainable business practices and risk management. Companies with strong ESG practices are often better equipped to navigate regulatory changes, reputational risks, and environmental challenges, which can contribute to long-term stability and profitability.
On the other hand, some critics argue that ESG funds may not always deliver superior financial returns, especially in the short term, as they might exclude certain high-performing sectors that do not align with ESG criteria, such as fossil fuels or tobacco. This can limit the investment universe and potentially reduce the funds' growth potential in certain market conditions.
However, evidence suggests that, over the long term, ESG funds can provide comparable or even superior returns to traditional funds. The increasing integration of ESG factors into corporate strategies and growing demand for sustainable investments are likely to continue driving the success of ESG funds, making them an attractive option for investors seeking both financial performance and positive social impact. As awareness of sustainability issues rises and more data on ESG performance becomes available, the gap between ESG and traditional funds' performance is expected to narrow, benefiting both investors and the global community.

3. ESG Regulatory Framework in India

The Indian regulatory environment has evolved to integrate ESG principles into corporate governance. Key regulatory developments include:

- SEBI's Business Responsibility and Sustainability Reporting (BRSR)
- RBI's emphasis on green financing
- The Companies Act's CSR (Corporate Social Responsibility) mandate
- ESG rating mechanisms for Indian-listed companies

India has made significant strides in developing a regulatory framework to promote Environmental, Social, and Governance (ESG) practices among companies. As the global focus on sustainability intensifies, the Indian government and regulatory bodies have increasingly recognized the importance of ESG factors in shaping long-term corporate strategies and investments.
The Securities and Exchange Board of India (SEBI), India's capital market regulator, has played a central role in encouraging ESG disclosures. In 2021, SEBI introduced the Business Responsibility and Sustainability Report (BRSR), which requires the top 1,000 listed companies by market capitalization to disclose detailed ESG information. This framework aims to align corporate reporting with global best practices, providing investors with the necessary data to assess a company's ESG performance. The BRSR focuses on key areas such as environmental sustainability, social impact, governance practices, and business ethics.
In addition to the BRSR, SEBI has mandated the integration of ESG disclosures into the corporate governance framework, encouraging companies to adopt a more transparent approach to their environmental and social responsibilities. These regulations are part of India's broader push to improve corporate accountability and align with international sustainability standards.
The Ministry of Corporate Affairs (MCA) also contributes to the ESG regulatory landscape through its guidelines on corporate social responsibility (CSR). Under the Companies Act of 2013, large companies are required to spend a portion of their profits on CSR activities, further fostering responsible corporate behavior.
India's regulatory framework is evolving, with increasing emphasis on sustainability and governance. As global and domestic investors seek to make more informed decisions, the country is positioning itself as a growing hub for responsible investing. The continued development of ESG regulations will likely lead to enhanced corporate accountability and contribute to a more sustainable and inclusive economy.

Investor Perspectives on ESG in the Indian Stock Market

1. Institutional vs. Retail Investors

Institutional investors, including mutual funds and foreign portfolio investors, have shown greater inclination toward ESG investments. Retail investors, however, remain cautious due to limited awareness and concerns over financial returns.
Institutional and retail investors are two key groups in the financial markets, each with distinct characteristics, investment strategies, and objectives.
Institutional investors are large organizations that manage significant amounts of capital. These include entities such as pension funds, insurance companies, mutual funds, hedge funds, and sovereign wealth funds. Due to their size and expertise, institutional investors typically have access to resources, research, and networks that allow them to make well-informed investment decisions. They often invest in large, diversified portfolios and may have the ability to influence corporate governance and policy decisions within the companies they invest in. Institutional investors typically focus on maximizing long-term returns and risk management, and they often have a longer investment horizon compared to retail investors.
On the other hand, retail investors are individual investors who buy and sell securities for their personal accounts. While retail investors typically invest smaller amounts compared to institutional investors, their numbers are vast, making them a significant force in the market. Retail investors usually have less access to the resources and expertise that institutional investors enjoy, and they may rely more heavily on financial advisors

or online platforms for investment guidance. Retail investors tend to have more diverse investment goals, ranging from short-term gains to long-term wealth accumulation, and they often have a more emotional or reactive approach to market fluctuations compared to institutional investors.

Both types of investors play crucial roles in the market. Institutional investors tend to have a more strategic, data-driven approach to investing, while retail investors bring liquidity and consumer confidence to the markets. As the lines between these two groups continue to blur, especially with the rise of online trading platforms and ESG-focused investing, the dynamics between institutional and retail investors will continue to shape the investment landscape.

2. Key Drivers Influencing ESG Investments

Several factors are driving the increasing popularity and adoption of Environmental, Social, and Governance (ESG) investments. These key drivers reflect changing investor preferences, regulatory pressures, and societal demands for greater corporate responsibility.

1. **Growing Awareness of Sustainability**: As environmental and social issues, such as climate change, inequality, and human rights, gain prominence, investors are becoming more aware of the long-term risks associated with neglecting ESG factors. The rise of sustainability-focused movements and increased public attention on corporate behavior have prompted investors to seek opportunities that align with their values and contribute positively to society.
2. **Regulatory Pressure and Policy Changes**: Governments and regulatory bodies worldwide are implementing policies that encourage or mandate ESG disclosures and responsible corporate practices. In many regions, regulations require companies to report on their environmental impact, social initiatives, and governance practices, making ESG factors more accessible and measurable for investors. This regulatory shift is pushing companies to adopt more sustainable practices and report them transparently.
3. **Investor Demand**: Institutional investors, in particular, are increasingly incorporating ESG criteria into their investment strategies. Many pension funds, endowments, and asset managers now view ESG as a key factor in identifying sustainable, long-term investments. Retail investors are also growing more interested in ESG investments, with many seeking to align their portfolios with their personal values, whether through environmental protection, social equity, or ethical governance.
4. **Risk Management and Financial Performance**: ESG factors are now recognized as key indicators of a company's long-term viability and risk management practices. Companies with strong ESG credentials tend to be better prepared for regulatory changes, reputational risks, and operational challenges, making them more attractive investments for risk-conscious investors. Research suggests that companies with solid ESG practices can often outperform their peers in terms of financial performance, as they are more resilient in the face of global challenges.
5. **Technological Advancements and Data Availability**: Advances in technology have made it easier to track, analyze, and report ESG data. Investors now have greater access to tools and resources that allow them to assess a company's ESG performance in real time. This data-driven approach enables better decision-making and helps investors make more informed choices when selecting ESG-compliant companies.
6. **Corporate Reputation and Consumer Preferences**: As consumers increasingly demand ethical and sustainable products, companies that prioritize ESG factors often enjoy stronger brand loyalty, enhanced reputation, and a competitive edge. Investors are recognizing the value of companies that are seen as responsible corporate citizens, as this can translate into better market performance and long-term growth.

These drivers, among others, are shaping the future of ESG investing, making it an increasingly integral part of the global investment landscape. As awareness continues to grow and investor priorities shift, the demand for ESG investments is expected to strengthen, driving further integration of sustainability into financial markets.

3. Challenges Faced by Investors

Despite the growing interest in ESG investing, investors face several challenges when incorporating Environmental, Social, and Governance (ESG) factors into their investment strategies. These challenges can complicate decision-making and affect the effectiveness of ESG investments.

1. **Lack of Standardized ESG Metrics**: One of the major hurdles in ESG investing is the absence of uniform standards for ESG reporting and measurement. Different companies, rating agencies, and countries often use varying criteria and frameworks, which makes it difficult for investors to compare and assess ESG performance consistently. This lack of standardization can lead to confusion, inaccurate assessments, and potential greenwashing—where companies overstate their ESG achievements.
2. **Limited ESG Data Availability:** While the demand for ESG data has surged, reliable and comprehensive data can still be hard to come by, particularly in emerging markets or for smaller companies. Inconsistent reporting and the absence of detailed disclosures in certain regions make it challenging for investors to evaluate companies' true ESG performance. The lack of transparency also increases the risk of relying on incomplete or misleading information.
3. **Balancing Financial Performance with ESG Goals:** Many investors are concerned about the potential trade-off between pursuing ESG objectives and achieving strong financial returns. While numerous

studies suggest that companies with strong ESG practices can outperform their peers, some investors remain skeptical, especially in sectors where ESG criteria may seem to conflict with financial performance, such as fossil fuels or certain high-emission industries. Striking the right balance between social responsibility and profitability remains a challenge.

4. **ESG Integration Complexity:** Integrating ESG factors into investment analysis requires significant expertise, resources, and time. Investors must adapt their strategies and models to incorporate ESG criteria without sacrificing returns. This may involve training teams, developing new tools, or collaborating with external ESG experts, all of which can be costly and resource-intensive.
5. **Greenwashing Risk:** As the popularity of ESG investing grows, some companies may engage in greenwashing—making misleading or exaggerated claims about their environmental and social efforts in order to attract ESG-conscious investors. Identifying and avoiding companies that overstate their ESG initiatives can be a challenge, particularly when reliable data and third-party verification are lacking.
6. **Regulatory and Policy Uncertainty:** While there is growing support for ESG regulations, the global regulatory landscape remains fragmented. Different countries and regions have varying requirements for ESG disclosures, making it difficult for investors to navigate and comply with multiple standards. Additionally, the evolving nature of ESG-related regulations means that investors must constantly adapt to new rules and frameworks.
7. **Short-Term vs. Long-Term Focus:** ESG investments often require a long-term perspective, as the benefits of sustainable business practices may not be immediately apparent. However, many investors, particularly those in the retail sector, are focused on short-term returns. Convincing investors to adopt a longer investment horizon, especially when financial pressures or market fluctuations arise, is a significant challenge for the ESG investment community.

These challenges highlight the complexities of ESG investing and underscore the need for greater transparency, standardization, and education. As the ESG landscape continues to evolve, investors will need to navigate these obstacles in order to make informed and responsible investment decisions.

Future Trends in ESG Investing in India

1. Enhanced ESG Disclosure Norms

Stronger regulatory requirements are expected to improve ESG transparency, making investment decisions more reliable.

2. Rise of Green Bonds and Sustainable Financing

India is witnessing a surge in green bonds and other ESG-driven financial instruments, offering new investment avenues.

3. Integration of AI and Big Data in ESG Analysis

Technological advancements are facilitating better ESG data collection, analysis, and investment decision-making.

4. Greater Retail Investor Participation

Awareness campaigns and financial literacy initiatives will encourage more retail investors to explore ESG opportunities.

CONCLUSION

ESG investing in India is at a transformative stage, offering both challenges and opportunities. While institutional investors have embraced ESG strategies, retail participation remains limited. The evolving regulatory landscape, enhanced ESG disclosures, and sustainable financing trends will shape the future of ESG investments in India. For long-term economic growth, integrating ESG principles into mainstream investing is imperative.

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