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SUSTAINABILITY, GOVERNANCE AND CAPITAL: REALITIES AND RISKS IN THE ESG ERA

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Abstract: *The introduction of Environmental, Social, and Governance (ESG) principles by the United Nations in 2004 marked a pivotal moment in global sustainability efforts, prompting widespread adoption of ESG frameworks within the corporate and investment sectors. ESG investing, which blends financial goals with sustainable values, has gained significant traction, driving innovations in financial products such as green bonds and ESG indices. This shift in investment strategies aligns with the United Nations' Sustainable Development Goals (SDGs) and is reshaping global markets, notably through exchanges like the Eurex Exchange, which launched ESG-focused financial products in response to rising demand. However, the ESG landscape is not without challenges. The lack of a universally accepted definition and the presence of competing ratings systems contribute to confusion and the potential for deceptive practices like greenwashing. Despite these issues, ESG investments continue to grow rapidly, fostering transparency and sustainability practices while posing risks related to unclear performance outcomes. Sustainability management at the company level includes not only environmental impacts but also social and governance dimensions, with strong reputational benefits for firms adopting comprehensive ESG strategies. By addressing interconnected environmental, social, and economic issues, businesses can foster competitive advantage, gain market trust, and contribute to a more sustainable future.*

Keywords: *ESG, Sustainability, Greenwashing, Climate Change*

JEL classification: *Q56, Q54, R11, E71*

1. Introduction

Since the United Nations introduced the concept of environmental, social, and governance (ESG) in 2004, it has quickly become one of the most widespread recognized ways to measure sustainability worldwide This transition has been driven by increasing pressure from all pushing companies to be more transparent about their ESG performance. But while this has encouraged businesses to improve their sustainability efforts, it has also created enough space for practices that aim to deceive such as greenwashing, value washing and blue washing. These tactics are often used to attract investments or satisfy stakeholder expectations without truly committing to sustainability. Sustainable investing through tools like green bonds and ESG indices is reshaping the way we think about finance in general. It blends environmental, social, and governance (ESG) values with traditional economic goals, all with the bigger picture in mind: building a more sustainable future. This approach is becoming a key pathway toward achieving the UN’s Sustainable Development Goals (SDGs). Around the world, investment in ESG assets is growing rapidly, setting a new trend in financial markets and highlighting the need for smart risk management strategies. One example of this shift is the Eurex Exchange in Frankfurt, Germany. In response to growing interest in ESG-focused financial products, the exchange launched futures based on the STOXX Europe 600 ESG-X Index in February 2019. Thanks to positive market feedback, they followed up with listed options on the same index in October of that year (Kanamura Takashi 2025). According to Aldowaish et.al (2022) sustainability at the company level covers various aspects, like how well products are recycled, sustainability challenges within operations and the strategies and business routines that a company adopts. A company’s sustainability reputation plays an important role in how customers perceive it. For example, one study found that a strong commitment to sustainability (like through CSR and ESG practices) positively impacts a company's reputation. Another study highlighted that public awareness pushes companies to develop better sustainability practices. Sustainability within a company is often defined as the ability to adapt to changes and identify opportunities to offer valuable services that are delivered both efficiently and effectively. Achieving this means balancing environmental, social, and economic factors to boost overall efficiency. The key management areas that specifically address sustainability include: corporate strategy, human resource management knowledge and innovation management, performance measurement, independent assurance and disclosure and integrated management systems. It’s been suggested that greenwashing occurs when companies lack the knowledge about how to properly integrate sustainability into their daily operations and strategies. Rising concerns about the environment have increased global awareness of sustainability issues, leading to a shift in investment strategies. Traditionally focused on maximizing profits, investors are now looking to support sustainability-focused initiatives. This shift is commonly referred to as Socially Responsible Investing (SRI), which involves integrating environmental, social and governance (ESG) factors into the investment decision-making process. ESG can be broken down into three main areas. Environmental factors assess how a company manages its impact over the environment. Social factors look at how a company interacts with its employees, suppliers, customers, and the communities where it operates. Finally, governance factors focus on a company’s leadership structure, executive compensation, internal controls, audits, and shareholder rights. Together, these factors serve as a set of criteria for evaluating companies during the investment screening process.

According to Hartley et.al (2020) in the traditional linear model of industrial production, resources are extracted, processed, consumed, 0and eventually discarded, which is a process often referred to as the “take-make-dispose” system. Efforts to promote sustainability have primarily focused on the final stage of this process, dealing with waste through management and recycling. While the linear model is deeply entrenched in industrial systems, there’s a growing shift among businesses, governments, and researchers to move away from it and adopt a circular economy (CE) model. The Circular Economy (CE) model not only aims to minimize waste but also encourages reintroducing waste back into production processes. As a result, research on CE policies largely centers around waste treatment, including approaches to eliminating waste from production processes. Key findings from the literature suggest that there are significant opportunities for waste reduction throughout the entire production process and product life cycle. Achieving this requires companies to invest in analysis, industrial reconfiguration, and worker retraining. Another important topic in the literature is the role of government purchasing decisions in advancing CE, particularly in the context of Sustainable Public Procurement (SPP). SPP is seen as a direct way to link policy with practice, and the combination of SPP and CE has been explored from various analytical viewpoints, including surveys and comparisons of different practices.

2. ESG and Sustainable Management

Environmental, social, and governance (ESG) investing faces a well-known challenge in clearly defining what it actually entails. Research has shown that even among funds that are supposed to follow ESG principles, there is significant variation in how specific ESG investment strategies are accounted for. Furthermore, there is a lack of consensus among ESG ratings, which often contradict each other or fail to align closely. Despite the massive scale and rapid growth of ESG investments, there is significant frustration over the uncertainty surrounding its meaning, goals, and performance. This uncertainty introduces a moderate level of risk—if ESG investments fail to meet expectations, it could lead to a large-scale outflow of capital, along with negative environmental consequences. The challenges in defining and managing shared resources are not new. In fact, Nobel Laureate Elinor Ostrom (1990) gained recognition for demonstrating that the prevailing theory of resource management at the time was too limited. This theory, often referred to as the “Tragedy of the Commons,” argued that the absence of private ownership leads to the depletion of shared resources. Initially, this theory was applied to overgrazing by livestock on common lands without clear ownership boundaries, and it was later popularized in an essay on population growth. Ostrom tested the validity of the Tragedy of the Commons theory through field studies in various real-world contexts, including water management programs across different countries. Her findings revealed that, contrary to the theory, the lack of private ownership of common resources did not always lead to mismanagement. Subsequent research has further suggested that the success or failure in managing shared resources is significantly influenced by broader social and technological factors, beyond just the ownership structure of the commons. ESG investing can also be seen as an effort to manage shared common resources. For instance, the environmental component of ESG, the “E” pillar, applies principles of private governance and investment tools to address the impacts of commercial and industrial activities on shared resources like air, land, and water. A key distinction from the problem of managing common resources, as explored in Ostrom's groundbreaking research, is that there is currently no widely accepted theory of ESG investing that investors can consistently rely on or test for accuracy and outcomes. As a result, investors, whether institutional or individual, find themselves navigating an uncertain ESG landscape based on loosely defined principles and varying preferences. An equally important issue of definition arises in the form of competing ratings and reporting systems, which claim to offer extreme precision in measuring the impacts of ESG investments—such as reductions in greenhouse gas emissions within the “E” pillar. The precision of emissions estimates may be misleading, with third-party estimates often failing to accurately reflect actual emissions. Even if the estimates were accurate in a specific case, these rating systems do not always align with the core values that drive ESG investing in the first place. It’s perhaps not surprising, then, that while ESG reporting has led to improvements in disclosure practices, tangible performance improvements in the real world have not always followed. The uncertainties surrounding ESG investment are not just theoretical because they have practical implications. Given the size of ESG investments, they play an important role in determining the effective allocation and performance of financial capital. The rapid growth of ESG funds is expected to continue. For instance, ESG fund assets are predicted to represent up to half of all European fund assets under management within the next three years, implying a compound annual growth rate of 28.8% from 2019 to 2025. The Asia-Pacific region is also experiencing rapid growth in ESG-related investments, particularly in fixed-income instruments. For example, the issuance of ESG- labeled bonds originating from the Asia-Pacific region has quadrupled since 2019, reaching over $24 billion USD. In contrast, the European Union, with its more technically advanced regulatory frameworks, faces both opportunities and challenges as a leader in this space. One such challenge is the need for coordination and harmonization across the region. A notable example is the proposed introduction of a European ESG benchmark label, which would complement the Benchmarks regime introduced in 2018. This initiative aims to enhance the quality of ESG benchmarks and reduce instances of greenwashing (European Securities and Markets Authority, 2022). While the ESG benchmark label offers the EU an opportunity to lead, it also requires careful attention to harmonization, especially as it affects third-party countries that were previously granted a compliance grace period, which is set to expire in 2023. Similarly, ESG regulations in the Asia-Pacific region are developing quickly, though there is considerable variability among the countries involved (Trahan Thomas Ryan, Jantz Brad 2022).

3. Benefits of Implementing Sustainable and ESG Management

Leading for sustainability presents significant challenges, largely due to the complex and interconnected nature of environmental and social issues. The concept of wicked problems is defined as situations where facts are uncertain, values are in conflict, stakes are high, decisions are urgent and a broad community of stakeholders is necessary to resolve the issues such as climate change, biodiversity loss, freshwater depletion, social inequality and food security. Transitioning toward sustainability inherently involves these characteristics, including stakeholder conflicts, ethical dilemmas, and various layers of uncertainty and interdependence. Addressing these challenges requires leadership frameworks and practices that are geared toward system-level thinking and collaborative actions across multiple boundaries. Alongside environmental sustainability, half of the interviewees highlighted the importance of economic sustainability, while over 40% emphasized social sustainability. Social justice emerged as an important component in the program directors' definitions of sustainability, with terms like "social," "justice," and "equity" being frequently cited. This suggests a clear emphasis on the "triple bottom line" which is about the integration of economic, social and environmental sustainability, as referenced explicitly in 33% of the interviews, complementing the traditional definition of sustainability as outlined by the Brundtland Commission: "meeting the needs of the present without compromising the ability of future generations to meet their own needs." The prominent focus on social justice is noteworthy, considering that most curricula primarily address environmental management and general sustainability concepts, with limited direct focus on social issues. Although, sustainability has the potential to serve as an overarching theme for leadership, programs should encourage thinking and action that go beyond maintaining the status quo and instead focus on concepts such as restoration, resilience, and other transformative approaches. Sustainability can provide a strong foundation for leadership training, particularly if students are inspired to envision a future characterized by ecological, social, and economic prosperity within a steady-state economy. Most individuals are not inherently driven to simply "sustain" and their motivation lies in creating a better world (Shriberg Michael, MacDonald Lindsey).

Regarding the environmental advantages in 2006, the United Nations (UN) introduced the Principles for Responsible Investment (PRI) to address the global demand for a framework that would motivate institutional investors to voluntarily integrate Environmental, Social, and Governance (ESG) factors into their investment strategies and ownership practices. The term "ESG" was first coined in 2004 in the report “Who Cares Wins: Connecting Financial Markets to a Changing World,” created by 20 financial institutions in response to a call from Kofi Annan, the UN Secretary-General at the time. The "Environmental (E)" factor primarily focuses on adapting to climate change, encompassing aspects such as resource usage, emissions, recycling, waste management, and greenhouse gas emissions. It also extends to broader environmental concerns, such as biodiversity preservation, pollution prevention, and promoting a circular economy. The "Social (S)" factor addresses issues related to inequality, inclusivity, labor relations, and investment in people and communities. It emphasizes workforce treatment, human rights, product responsibility, and fostering trust and loyalty among stakeholders. Lastly, the "Governance (G)" factor deals with the governance of both public and private institutions, including management structures, employee relations, and executive compensation. This factor is crucial in ensuring the integration of social and environmental considerations into decision-making processes while adhering to best-practice corporate governance standards. Companies that prioritize ESG principles may benefit from improved access to capital and reduced borrowing costs, largely due to their strong reputation. Investors and partners across the value chain are increasingly drawn to companies with robust ESG performance. As a result, these companies often find it easier to secure funding, negotiate favorable loan terms, and enjoy lower interest rates. Also, companies with a solid reputation are viewed as less risky compared to those with similar financial performance but weaker reputations. ESG initiatives help build trust between investors and managers, reducing information asymmetry and lowering adverse selection costs when raising equity. Additionally, companies excelling in ESG performance often attract more media attention and appeal to socially conscious investors. Additionally, being part of networks boosts a firm's ability to identify and create innovative opportunities that might otherwise be overlooked. As a result, enhanced innovation performance and the benefits of social capital lead to structural changes within the firm that support a sustainable competitive advantage. The concept of competitive advantage refers to the distinct resources, capabilities, qualities or strategic positioning that allow companies to outperform their competitors in the marketplace. Achieving a competitive advantage is crucial for firms, as research has demonstrated its strong correlation with several favorable outcomes (Cerviño Cabaleiro Goretti, Mendi Pedro).

4. Conclusion

The rapid growth of ESG investing reflects a shift in both the financial and corporate landscapes, where sustainability is increasingly intertwined with economic decision- making. Although the framework offers promising benefits, particularly in promoting transparency and encouraging better corporate practices, the current state of ESG investments is fraught with challenges, including the lack of consistent definitions and the risk of misleading claims. The adoption of ESG principles by companies leads not only to environmental benefits, such as waste reduction and resource conservation, but also enhances social outcomes through improved labor relations and community engagement. Furthermore, companies integrating ESG factors into their operations often experience better access to capital, lower borrowing costs, and enhanced reputations, leading to a competitive advantage. While the path toward widespread ESG integration remains complex, the continued expansion of ESG-focused financial products and the growing awareness of sustainability issues offer a promising framework for achieving both business success and global environmental goals. To fully realize the potential of ESG investments, however, a more standardized approach is needed to reduce uncertainty, promote accountability, and mitigate the risks of greenwashing.

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