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CORPORATE SOCIAL RESPONSIBILITY

ESG and the Changing Language of Corporate Social Responsibility

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ESG shifted the language of corporate social responsibility from a values-based discourse to a value-based discourse.

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Introduction

ESG started as an initiative to integrate environmental, social, and governance issues into investment decision-making but has transcended the financial sector and permeated political rhetoric, morphing into a polarizing yet ambiguous reference in business and society.[1] In a 2024 documentary film by the Financial Times, titled "Who Killed the ESG Party?"[2] the ambiguity of the ESG reference was on full display, and with it, the various points of view laid out in grandiose expressions such as: "ESG is the next evolution of capitalism…" "…when we talk about ESG, we are talking about the future of humankind." "…the story of ESG is a multi-trillion-dollar marketing scheme." "…humanity responding to a set of inconvenient truths with something short of real solutions." These expressions lay a heavy responsibility on ESG, a term lacking formal theorization or standardization. The ESG literature also conflates several related references, creating a convoluted discourse around the language, and espousing an amorphous concept that can be shaped to serve many different pursuits. But what is ESG and what does it represent in the language of corporate social responsibility?

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While the ESG reference only entered the business lexicon in the last 20 years, what it embodies has long been present through articulations such as corporate social responsibility (CSR) and socially responsible investment (SRI). However, ESG's most fundamental departure has been the reconfiguration of corporate social responsibility and responsible investment from a values-based discourse, motivated by the moral responsibilities of companies and investors, to one that is value-based and aligned with the pursuit of financial performance. This has had the impact of aligning corporate social responsibility with the language of investors where financial risk and corporate value creation define decision-making.

The ESG language, however, lacks a clear conceptual boundary and is often conflated with CSR and SRI. This article discusses the antecedents of ESG (i.e., CSR and SRI), the delineation between them, and argues that ESG has promulgated its relevance through financial performance as its primacy. Within these discussions, the article further highlights the impact of ESG ratings on the proliferation of ESG despite concerns about the lack of usefulness of aggregated ESG ratings.

ESG Origin

ESG is an acronym for environmental, social, and governance and first appeared in a series of reports published through the *Who Cares Wins* initiative from 2004 to 2008, led by the United Nations Global Compact, which sought to increase financial institutions' understanding of ESG-related opportunities and risks while enhancing the integration of ESG factors into investment and asset management decision-making[iii]. The output of these endeavors would form the origins of the ESG reference through the publication of a series of UN reports between 2004 and 2008, listed below.

- *Connecting Financial Markets to a Changing World* (2004).
- *Investing for Long-Term Value* (2005).
- *Communicating ESG Value Drivers and the Company-Investor Interface* (2006).
- *New Frontiers in Emerging Markets Investment* (2007).
- *Future Proof? Embedding ESG issues in Investment Markets* (2008)

Each of these reports focused on a particular aspect of ESG awareness and understanding, and the final document provided recommendations to enhance ESG integration with financial markets.

Further support for ESG adoption came in 2005 through the *Freshfields Report*, commissioned by an asset management working group formed by the UNEP FI (United Nations Environment Programme Finance Initiative) which investigated the legal ramifications of ESG in the context of fiduciary responsibility. The report, produced by law firm Freshfields Bruckhaus Deringer, concluded that[4]

> *"Conventional investment analysis focuses on value, in the sense of financial performance… the links between ESG factors and financial performance are increasingly being recognized. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."*

The *Freshfields Report*, together with the *Who Cares Wins* initiative influenced a transition from the traditional values-based articulations defined by socially responsible investment (SRI) and corporate social responsibility (CSR) to one that is value-based, with financial performance as a primacy. Based on an ethnographic study of financial analysts, at a Swiss bank between 2010 and 2012,[5] ESG has allowed financial analysts to

> *"…reframe moral concerns in a way that meant they could be used to underpin the motives of investors who were primarily looking to increase their financial returns."*

This value-based framing of ESG has influenced adoption well beyond what has previously been experienced by predecessors such as SRI and CSR. However, while the ESG language proliferated, it was never grounded in any theorization, which would lead to divergent, though overlapping, discourses that stemmed from differences in the conceptualization of the language and its operationalization.

ESG would then evolve through a constructivist epistemology, where users of the language (academics and practitioners) create an understanding of the meaning and ultimate usage based on interactions between existing knowledge, experience, and perhaps personal philosophies that underlie environmental, social, and good governance issues. Organizational origins, philosophies, and mission goals shape the deconstruction of ESG measurements. Using historical document analysis and in-depth interviews with the cofounders of KLD (Kinder, Lydenberg, and Domini) and Innovest (two of the earlier providers of corporate sustainability data and research), researchers show that the value-based data approach of Innovest, over the values-based data approach of KLD, would dictate relevance after both firms were acquired by MSCI in 2009.[6] Furthermore, this value-based data preference has not just created a new approach to measuring environmental and social issues but has also reshaped perspectives on environmental and social issues from moral and ethical outcomes to more financially focused outcomes.

ESG Antecedents

While ESG as a language was conceived in 2004, much of the discourse embodied in this language has been previously articulated through references such as CSR and SRI, and their underlying concepts further predate these references. CSR has an extensive history, though a formal literature only started to emerge during the 1950s, with Richard Bowen's (1953) *Social Responsibilities of the Businessman*. Early discourses on CSR concerned the societal responsibilities companies should be expected to assume based on their possession of social power, the influence on societal decision-making and outcomes, and the potential impact these decisions and outcomes have on society.[7] These conversations were also heavily shaped by the issues of the period, such as civil rights, women's rights, consumer protection, and environmental protection, with some conversations extending to the implications of CSR for firm value maximization.[8] These latter implications conceived a new perspective on corporate management termed stakeholder theory, positing that companies should pursue long-term value creation for all their stakeholders, not just their shareholders.[9] This represented one of several discourses that splintered from the evolving CSR literature. Attempts to reconcile stakeholder and shareholder theories resulted in a large body of literature that investigated the relationship between CSR and firm value with a shift towards a more strategic CSR that is focused on corporate value creation.

ESG also shares similarities with another predecessor, SRI, which like CSR has had an extensive history weaving through shifting discourses. SRI's original language can be ascribed to ethical investing, which has its roots in the investment pursuits of religious groups and their restrictions against 'sin' activities such as alcohol, tobacco, and weapons manufacturing, gambling services, or other activities that challenged the principles of their religious beliefs.[10] SRI evolved from an exclusionary practice that disregarded unethically labeled companies (negative screening), to an exclusionary and inclusionary practice that considered investments based on negative and positive screening criteria, and later evolved to the more contemporary shareholder activism approach that involves investing in companies and using shareholder power to effect change.

Shareholder activism, in some cases, has also interconnected the SRI pursuits of large investors with desired CSR adoption through the influence of investors.[11] An important delineation is that CSR has always been directly focused on corporate governance as the locus of corporate responsibility whereas SRI and ESG have positioned investors as the point of focus. Both SRI and CSR, through their tenured history, have also struggled to converge to a standard definition and operationalization, an issue that has been maintained with the ESG reference, and one that has probably created the most divergent discourses for ESG, which has been most prominent through the discourse on ESG ratings.

ESG Ratings

ESG ratings are aggregated ESG measurements that are used to express an opinion on the ESG performance of a company. ESG rating agencies occupy an information intermediary role, much like financial institutions as intermediaries of financial capital. This information intermediation allows the exertion of influence on the propagation and usage of rating information, which impacts ESG adoption. Rating agencies interact with existing stakeholders in the rating field while competing for dominance and these interactions shape the language around ESG and the evolutionary direction of its discourse, which influences the institutionalization of ESG ratings.[12]

A large body of literature has shown that ESG performance (measured by ESG ratings) is generally positively correlated with corporate financial performance[13] but the ESG literature also shows that ESG ratings do not predict or explain ex-post ESG performance accurately.[14] ESG ratings then do not provide informational value but rather serve an institutional certification role for credulous ESG investors seeking validation for asset selection choices. Beyond, this institutional certification role, ESG ratings have certainly influenced the value-driven ideology around ESG through the quantification of ESG concepts and, in effect, have also shaped the discourse around ESG through this lens of quantification promulgating the institutionalization of the value-based approach through the information intermediary role that ESG raters have occupied. ESG raters are positioned as a new form of intermediaries that "…centralizes the task of assessing corporate environmental and social performance and provides to the investment community a set of signals that facilitates the creation of 'socially responsible' financial products."[15] However, the apparent inconsistencies and validity questions surrounding ESG ratings have led to many ESG detractors. How will corporate professionals continue to navigate the ESG space, and how will the ESG discourse evolve?

ESG Relevance

Quoting Alex Edmans, "ESG is both extremely important and nothing special."[16] The author argues that ESG is extremely important because it is a driver of long-term company value, and also nothing special because it is not generally superior (or inferior) to any other drivers of long-term company value. As a set of value-relevant factors, ESG is important for and will remain relevant to long-term value. Edmans also argues that the practice of ESG needs to evolve to a state of ESG value creation and away from the perfunctory disclosure practices focused on "ticking the box",[17] an action that fails to identify issues material to core business activities.

Several authors have argued the essence of materiality in engaging ESG on major issues that are relevant to businesses and focusing on key performance/materiality indicators.[18] The materiality of ESG issues, however, can be complex with large heterogeneity across industries and can further possess an evolutionary property whereby issues can transition from a state of immateriality to one of materiality through stakeholder, company, and regulatory reactions to catalyst events.[19] Materiality becomes even more complex due to the diverse range of company stakeholders and their heterogeneous expectations or demands matched against the commitments of the company and what is perceived by the stakeholders.[20] As regulations around ESG disclosures develop, emphasis should shift on how to report rather than what to report, allowing companies the flexibility to internally define and establish material issues and externally report them in a transparent and verifiable way beyond just meeting compliance requests.

Conclusions

ESG has been in use for only 20 years, but the concepts it embodies have existed much longer through references such as SRI (socially responsible investment) and CSR (corporate social responsibility). These predecessors, however, cultivated a values-driven approach to corporate social responsibility. The basis of the ESG language is a shift from this values-driven to a value-driven approach centered on financial performance. ESG is about financial or corporate performance, whether through the lens of risk management (reducing the negative impact of externalities on the firm) or through the lens of value creation (creating opportunities through the reduction of negative externalities on society).

Despite this value-driven foundation, ESG issues remain deeply normative, with political, social, and temporal contestations on what should be relevant. This has led to polarizing conversations within the ESG discourse. Additional conflicts have emerged due to the misappropriation of ESG disclosures (greenwashing), and validity, reliability, and efficacy issues related to ESG measurements (ESG ratings). Despite these issues, ESG has advanced the conversations on corporate sustainability through the lens of corporate performance and has irreversible forged sustainability reporting into formal business practices. These outcomes are visible through regulatory disclosures such as the EU's CSRD (Corporate Sustainability Reporting Directive) and CSDDD (Corporate Sustainability Due Diligence Directive), and US regulations on climate disclosures being put forward by the SEC (Securities and Exchange Commission).

ESG remains at the forefront of many companies' agendas, but the language has become divisive. The ESG discourse needs to be redirected to its original intent, which is to embed material E, S, and G issues into capital allocation decisions. Materiality needs to be a focus for regulators so that companies are not burdened by unnecessary compliance reporting. Long-term value drivers are key to ESG materiality. Work on ESG needs to evolve towards effective accounting and reporting standards that engender transparency and verifiability. If companies focus on defining KPIs (key performance indicators) around ESG materiality, the demand for [aggregated] ESG ratings will naturally diminish but raters will maintain an important data provisioning role. Stakeholders need data that can be transformed into relevant information to support quality analysis. Stakeholders do not need a rating that conflates independent and diametric attributes into a point metric. Regulators need to support ESG reporting that ensures that relevant and material information is being disclosed in a manner that will be informative to stakeholders. Emphasis should be on how to report and not what to report.

Endnotes

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