

**An Exploratory study on the rise of Environmental, Social Governance (ESG) funds and offices in the world and the Indian market. Evaluating their progress; exploring the role of policy nudges and investor sentiment in shaping ESG adoption**

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DOI: 10.46609/IJSSER.2025.v10i10.020 URL: <https://doi.org/10.46609/IJSSER.2025.v10i10.020>

Received: 2 October 2025 / Accepted: 19 October 2025 / Published: 25 October 2025

**ABSTRACT**

*The importance and relevance of ESG has been increasing in recent years, one of the important impetus has been the adoption of the Paris Agreement. Firms all over the world have been mandated by the market and the government to add ESG in their portfolio selection. This paper analyses the history and the reasons for their increasing importance as well as the impact that these funds have had on investing choices of investors. How has the inclusion of these goals added to the profitability of the firms in the long run? What are the steps that have been introduced in the Indian Stock market to increase their usage? What are the 'nudges' that have been implemented by the government to ensure that these mandated goals are being adhered to?*

**Key words:** ESG, Nudges, Pension and retirement funds, financial stability, stakeholders, supply chain, ESG leaders Index, stakeholder capitalism, shareholder capitalism

**1. Introduction**

ESG (Environmental Social Governance) funds are not a recent phenomenon. It has its history that dates back to the 'Methodist Era.' The word ESG implies that firms, in their production choices, take cognizance of factors that impact Environment, *Society*, and the type of *Governance* that exists in the country of its origin. This is along with the other parameters that the firms must take into account while investing, like financial stability of the company in which they plan to deploy their capital.

The term environment means the way the company has worked in safeguarding its surroundings.

Social criteria is the relationships that exist at work among the employees as well as with their

superiors and owners.

Governance means the company's leadership, executive pay, audit and internal controls and shareholder rights.

Investing in ESG funds means that responsible citizens would like to evaluate whether the fund follows the principles indicated when the fund is labeled an 'ESG' one.

Further investing in these funds (ESG) has a larger horizon than CSR (Corporate Social Responsibility). When investors decide to invest in these funds, it means that they have considered a large gamut of things that include;

**1.1 Environment:** direct impact could involve investors evaluating factors like climate policy, energy use, waste, pollution, natural resource conservation, and possibly treatment of animals. Other factors that may also be considered are direct and indirect emission of toxic waste. Indirect could be whether in the manufacture of intermediate products sustainable practices are being adopted. Whether strict compliance of environmental regulations is being followed.

**1.2 Social factors:** A company's relationship with internal and external stake holders. They include the impact on all the people they deal with; be it their customers and/or their employees and even the larger community. This can be further subdivided into the relationship between:

Employees and Human capital; involving following fair practices in the disbursement of wages, as well as safe working conditions, and providing the environment for growth. Companies that adhere to this practice encourages robust health among its workers by ensuring a work life balance. They also take cognisance genders equality and the possible control of racism that may exist at the workplace.

A company that follows ESG norms, ensures that each section of workers is represented.

**Fig1; Visualisation of ESG**



Source: google image

### **1.3 Customer and Product Responsibility**

This involves;

- Customer Satisfaction- adhering to the highest standards in dealing and addressing customer queries; solving them in a manner that the customer is completely satisfied.
- Data protection and privacy; In today's world given the rampant spread and use of technology the possibility of data being misused and being stolen is a reality. Firms following ESG practices ensure protection of consumers personal and other data.
- Product safety: care is taken in ensuring that all the products that emerge from them are safe for use and meet the highest safety rules.

### **1.4 Community and Stakeholder Engagement**

These companies engage with as well as contribute to the community in terms of philanthropic activities , funding and promoting projects that help in empowering the marginalised in society. They work with all stakeholders and do not restrict their focus on the provision of profits only to its shareholders. The aim of such firms is to go well beyond the '*profit motive*'.

### **1.5 Supply chain and Human Rights**

These firms follow ethical practices with respect to the provision of ethical practices in all its dealings, sticking to human rights standards throughout the supply chain, and also preventing abuses in its production process in the form of forced labour and child labour.

## **2. Research Gap and Methodology**

The paper analyses the following;

1. The reasons for the sudden importance of the inclusion of ESG in portfolio management; their rise and importance.
2. Given the high costs involved in their adoption, would this investment have a positive impact on the firm's financial health?
3. Have they been adopted by both developed and developing countries, if so which ones and how? How have Governments used 'nudge' theory to increase their inclusion?

The study uses accepted, authentic secondary data in researching the data with respect to these funds. It uses the mixed-method approach with a greater emphasis on quantitative analysis to evaluate the use and the spread of ESG in portfolio management. As it is a recent phenomenon, with its awareness growing the data used would be for the last five years, effectively from 2015 onwards, discounting the Pandemic years. Wherever possible clarifications on the use and applicability of data would be clearly mentioned.

The secondary data has been sourced from reliable and official sites of the countries and companies considered. Complementing this, qualitative data has been analysed to provide a better understanding of the impact. Limitations and problems that arise are also mentioned and so have the possibilities to improve their working and acceptance.

## **3. Reasons for the rising Importance of these funds**

Recent data have indicated the rising adoption of ESG funds both in Developed and Emerging economies of the world. The Emerging Markets ESG Leaders Index has outperformed the broader MSCI (Morgan Stanley Capital International) Emerging Markets Index (April 2020). The awareness has been so phenomenal that according to the US Social Investment Forum Foundation's 2018 report that about 25% of the funds under professional management in the US are invested in a responsible manner.

KPMG Survey of 2017 has indicated that emerging markets like Africa, Middle East, Eastern Europe, and Latin America lagged North America and Europe. The report has also stated that two

EME (Emerging Market Economies) namely Mexico and Taiwan had experienced the fastest growth in 2015, and four countries-India, Malaysia, South Africa, and Mexico have the highest level of CSR activities.

The increasing trend towards these funds indicates that the firms are moral, well run and definitely more prepared for long-term success. These companies believe more in *stakeholder capitalism* rather than *shareholder capitalism*. This is a form of *inclusive capitalism*. Covid 19 pandemic has in fact accelerated companies to move towards 'inclusivity', as it is an essential factor important for resilience and long-term recovery. The fact that a large number of firms treated their staff well during the pandemic led them to understand the importance of 'S' in 'ESG'. Those companies that let go of their staff during the pandemic, and did not stand by them are likely to lose out on business when things return to normal as the best talent will look for placement elsewhere as they would not like to work in a place where they have been abandoned.

The movement towards these funds are so strong that investors are taking cognizance of whether the firms are following the 'ESG' protocol. Compared to the period before the pandemic, non-financial performance was considered more frequently when investment decisions had to be made.

#### **4. ESG Funds as opposed to those that do not include stake holders**

The importance of the ESG factor has been growing in importance for financial decisions. Progressive and mainstream investors are driving their increasing demand. For the first time these investors have recognised the fact that "climate risk is investment risk" (Arvidsson and Dumay, 2022)

The theoretical framework in understanding the importance of ESG performance can be ascertained through the following theories:

- Stakeholder theory- this theory states that firms should make decisions which are aligned to the interest of groups or individuals who could be affected by the activities of the company. (Garcia et al., 2017)
- Agency theory- this emphasises on the alignment of the agent (company's management) with the interest of the principal (typically shareholders), that takes the form of shareholder value creation (Jensen and Meckling, 1976). This theory aims at increasing profits of its shareholders, increasing the value of the company. The main goal under this theory for its managers is to increase profits, and their remuneration are aligned towards this end. This might lead to a conflict of interest as the management knows the benefits involved in following ESG goals, but as they are answerable to the shareholders they may

adopt less than optimal steps in trying to placate both.

- Institutional theory-This theory states that the impact of following ESG policies is stronger in regions that boast of a strong institutional framework. The main institutional factors that are considered important are- marketisation, regulatory frameworks, government intervention, and financial market development. These may vary across regions in a country impacting ESG goals.
- Resource based theory-This is a managerial format that understands the importance of scarce resources that a firm can use to attain a situation of comparative advantage.

## **5. ESG Investment Index**

Given the importance of ESG in recent times, the ESG index has been developed to understand the various aspects that should be included and analysed. The stock index when combined with ESG criteria gives the ESG index. But there is a basic difference between the two, as the selection of companies in the ESG index, include sustainability criteria, along with the other criteria like factors market capitalisation, and stock trading liquidity. The above factors are weighted differently in the calculation of the ESG index.

Each company is assigned a score on a 12-level scale from D - to A+, a company must have an ESG impact of C+or above to be included in the index.C+, means that the company is not included but is making a sincere effort in achieving ESG goals. To calculate an ESG rating, data with respect to a Company's impact on production practices and products on the environment as well as society across the life cycle of the product- right from when the product is in use till the time it has been disposed of is considered. The data gets uploaded periodically, and the ESG rating methodology is regularly amended according to the developments that take place in the market.

## **6. Alignment of the ESG index with the regular Stock Index**

The increasing importance in ESG activities have led to the rising interest and focus on investors decisions with respect to activities connected with it namely:

- Environmental protection
- Pollution Control
- Development of renewable energy

Large sums of investors' capital are invested in firms that take cognisance of the above stated

factors. Recent research work has pointed towards a remarkable increase in equity funds that are aligned to ESG principles (Chen and Lin 2022).

The US Social Investment Forum Foundation in its report of 2020 indicated that ESG criteria was the foremost consideration for investment.

**Table 2: Depiction of funds allocated for ESG**

Year	Amount of equity funds allocated according to the ESG criteria
2020	\$13.45 trillion <sup>1</sup>
2021	\$37.8 trillion <sup>2</sup>
2023	\$30.3 trillion <sup>3</sup>
2025	\$53 trillion <sup>4</sup>

1. US Social Investment Forum
2. Bloomberg
3. Global Sustainable Investment Alliance
4. Projected Estimates by Bloomberg.

There are studies that indicate that it may be extremely difficult to evaluate “climate risk”, (Stroebel and Wurgler 2021), and prices of assets tend to be under rather than overestimated with respect to risk valuation.

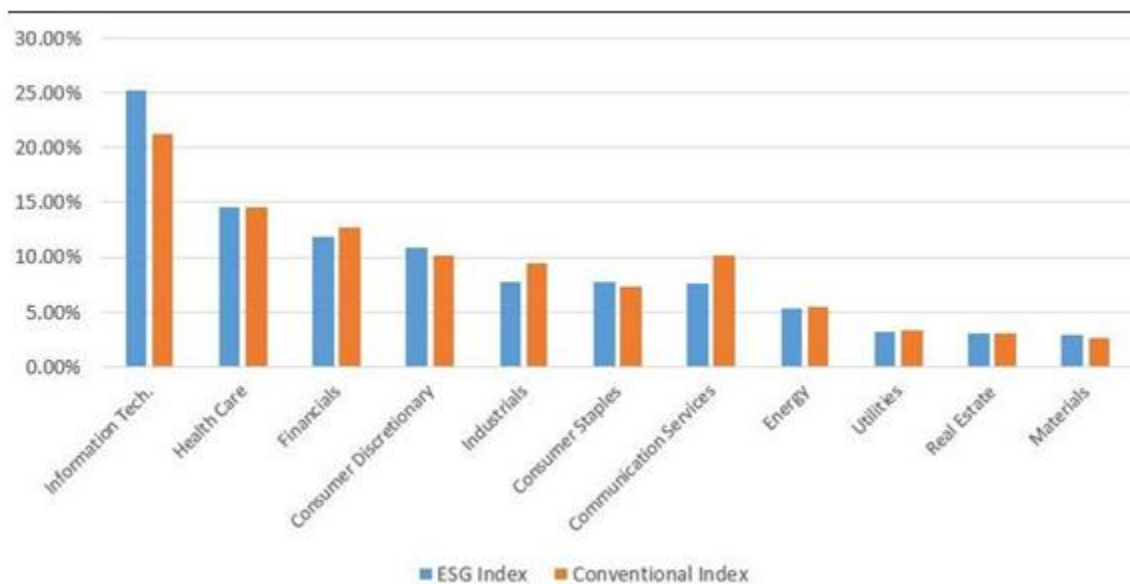
Studies point to the asymmetric nature of transmission of volatility, as some markets are more prone to transferring volatility, while others are more sensitive in receiving them. With increased globalisation and liberalisation, the shocks in one market is likely to lead to a chain reaction, resulting in increased volatility.

Markets that are highly liquid and institutionally developed tend to be greater transmitters of volatility. Among these the North American market, which is a global financial leader, is a natural influencer to the other world markets. As the North American dominant markets are influenced strongly by investor demand, regulatory mechanisms and ESG component; any change in these factors lead to transmission to other stock markets of the world.

With the inception of the S&P North America’s ESG Index, the impact is widely felt throughout the world in different ways namely;

- Any news regarding ESG tends to be transmitted to the valuation of the stocks, which are then transmitted across the world, both for developed and developing economies.
- The impact on those stocks in various markets are worse if they are not following ESG norms, and as in when the importance of ESG factors are included, it increases the reactions to changes in these indices.

**Fig 2; Comparison of the S&P 500 index (ESG and Conventional) for 2019**



Source:S&P Dow and Jones Index (April 30<sup>th</sup> 2019)

Factors like Greenwashing (falsifying statements by firms regarding their ESG commitments) are at times incorporated to falsify reports that can further influence investors decisions.

The increasing importance of ESG factors have introduced a new level of dynamics in the financial markets, including the transmission of volatility across various asset classes. There are differences of the impact in the long term, medium term and short-term investing decisions.

### **7. Long term, Medium term and Short term Impact on Firms that follow ESG**

There has been a growing clamour to indicate ESG exposure by various firms in their annual reports. This can be seen in the increased numbers of sustainability reports released by various

firms. In 2022 98% of S&P 500, and 90% of Russell 100 companies announced their sustainability reports which was way higher than the 20% released in 2011. As ‘climate risk’ becomes an important reality, it is essential for investors to have complete knowledge on the preparedness of the companies with respect to this aspect when they are considering investing choices.

Research and subsequent theories are pointing to the fact that firms with greater ESG compliance are likely to perform better under ‘crisis’, than those that do not. The increasing importance of this aspect has taken on unprecedented importance especially after the ‘Paris Agreement’, and the growing clamour for ‘net zero’ commitments. Following this path may impose immediate costs but it will eventually lead to long term gains for the firms. The eventual impact will depend on the size of the firm, market structure and its market visibility. There are indications that the immediate costs in adopting ESG initiatives is high, but in the long run firms capitalize on their sustainability investments. The greater the emphasis by firms on ESG goals the greater the resilience of these firms to mitigate risks in the long run. Pension and retirement funds looking for a long-term investment horizon definitely look at ESG compliant firms in providing options that are less risky compared to other firms. It has been concluded by various researchers that companies that address ESG goals are better equipped and resilient towards any unforeseen risk that might come that way and are unlikely to make a loss. This is an important factor for long term investors. Short term investors looking for short speculative gains may not necessarily give a high weight age to ESG factors. Medium investors would look at both the aspects before deciding on their investment choices.

#### **8. The limitations of various studies have brought out the following factors;**

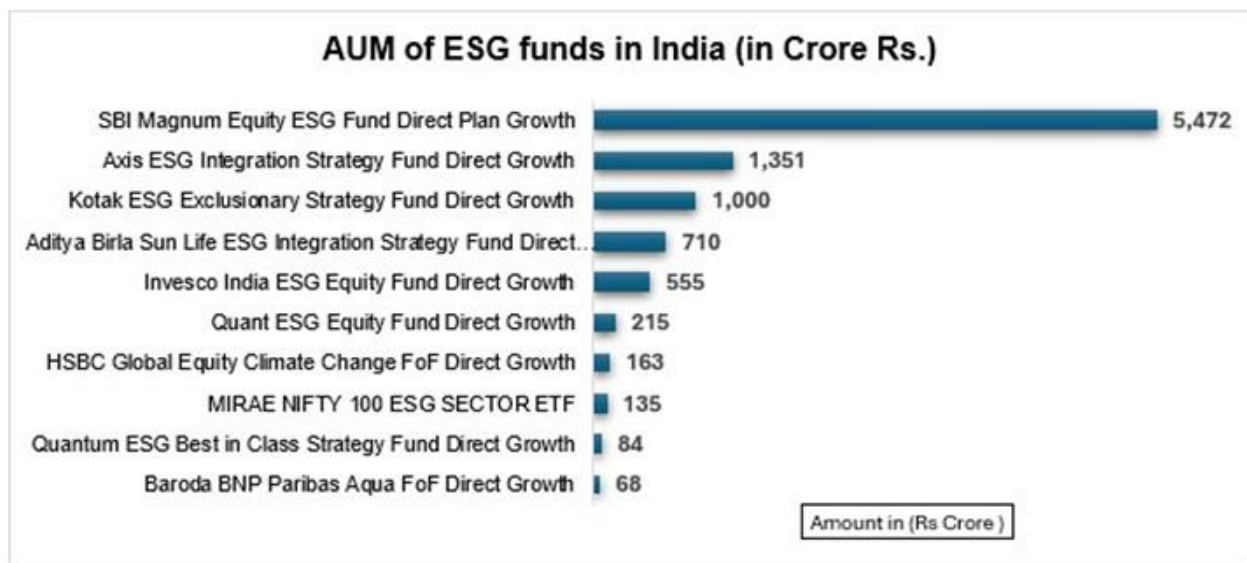
1. The measurement of ESG performance lacks standardisation. There are several discrepancies that lead to problems in comparing companies’ ESG profiles, and their substantive ranking. (Berg et al., 2022)
2. While comparing firms functioning in developed and developing nations there are difficulties in categorising terms like ‘corporate governance’, and ‘firm characteristics’, leading to difficulties in categorising them all of them under the same head.
3. A large number of analysis have concentrated on internal factors with respect to ESG performance rather than on the external factors, as they are easier to measure and compare. This does not lead to a correct measurement as it is the *external factors* which are primarily responsible for the working of the *internal ones*. The qualities of the ESG are driven by externalities and they are connected to both individual decisions as well as to regulations, institutional frameworks and societal inclinations.

4. Climate risk is difficult to value and thus hedge, creating problems in finding appropriate hedging instruments.
5. Investors may not have sufficient information that could help them conduct authentic risk analysis.

### 9. Importance of ESG compliant funds in India

Between 2012-2020 India introduced six ESG funds. As of 2024, the actively managed funds represent 96% of the total AUM (Asset Under Management).

**Table 3: AUM (March 3<sup>rd</sup> 2024)**



Source: GROWW

The Indian Government through its regulatory watch dog SEBI, has been introducing guidelines on a regular basis, the latest one that has been introduced in 2021 is that *it is obligatory for the top 1000 listed companies to report on sustainability.*

According to Avendus Capital a leading investment bank in India ESG goals are going to play an extremely important role in the Equity Market. The increasing importance is going to be fueled by sectors that have focused on ESG namely renewable energy, electric vehicles, green hydrogen and climate technology. Firms committed to this growth are going to witness greater investment in the near future. The major sectors where these goals are expected to be adhered to are;

- Banking

- Financial services
- Insurance
- Information technology
- Healthcare

The main reason for this increased interest is the policy nudges instituted by the Indian Government in the form of the following;

- 1) India's commitment to achieve a 'net zero', target by 2070.
- 2) SEBI's introduction of BRSR (Business Responsibility and Sustainable Reporting)

This is a mandatory framework for listed companies to prioritise sustainability. This has been compulsory for top 1000 listed companies by market capitalisation to file annual BRSR reports giving details on their ESG compliance. The report requires mandatory as well as voluntary disclosures (for advanced implementation of ESG norms). Besides this SEBI has introduced stringent norms in the form of third-party verification for certain key mandates under ESG.

Further laws mandated by SEBI, require the value chains of the listed companies to file that their supply *chains are following ESG guidelines*. Strict laws have been passed with respect to insider trading; this conforms to the 'G' part of ESG norms.

- 3) The Indian companies are expected to follow the UN'S SDG (Sustainable Development Goals) as a benchmark to raise capital.

## **10. Conclusion**

ESG goals have become imperative standards to follow for both developed and developing economies. Climate risk, carbon footprints as well as adverse impact of greenhouse gases have created havoc in the world. These have in turn been disastrous for sales and revenue figures for all companies. Research has indicated that though the short-term effect of the following may be expensive, the long-term results are definitely one of higher profitability and robustness for all firms, irrespective of whether they are operating in developed or developing economies. Their improved performance in fact attracts higher private investment from various long-term sources like pension and retirement funds eventually adding to the firm's profitability and growth. This can clearly be seen in the funds' performance at the stock market.

India too has committed to ESG norms over the years. They have implemented it through SEBI, playing an important role in adhering to all the pillars of ESG, especially the G. A large number

of investors are taking into account the ESG component before investing.

Concerted efforts in continuous emphasis on the importance of ESG from all fronts would help in mitigating climate risks and also help in better profitability of firms.

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