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"Financialized ESG and the Future of Corporate Strategy: Towards a Framework of Competitive Sustainability"

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In the preparation of this thesis, external digital tools providing language support were consulted in order to assist with grammar checking, sentence structure, and the overall linguistic clarity of the text. In particular, writing assistance software such as Grammarly was used solely for editorial and language refinement purposes.

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All ideas, arguments, interpretations, and findings presented in this thesis are the result of the author's independent research and critical work. The author therefore assumes full responsibility for the content of the thesis and for the proper acknowledgment of all sources used.

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Abstract

This thesis aims to explain the way corporate responsibility evolved from the classical conception of Corporate Social Responsibility (CSR) to the current Environmental, Social and Governance (ESG) principles, analyzing the way sustainability has evolved from a normative and voluntarist theme in companies to a more institutional and even financial component of the management of organizations. The purpose of this dissertation is to contribute to the literature on ESG in two ways: To clarify the implications of ESG for corporate governance, for the management of risk and for competition in market economies, and to explore the managerial choices available to directors in the face of the new demands of the markets.

In Chapter I there is a brief review of the theoretical foundations of CSR, through a brief exploration of the evolution of the stakeholder theory, the shareholder theory and, more generally, the historical debate concerning the purpose of companies. This is with a view to shedding some light on how these theories all merged, in a CSR formulation, structured and financially-oriented, which led, subsequently, to the emergence of ESG. In this Chapter we particularly focus on how sustainability has gradually evolved from being a moral principle to a quantifiable, quantified and therefore capitalizable responsibility that has, in the meantime, become a factor of real economic value in the markets and in the practices of business. This evolution took place, among other things, because sustainability has become a material factor for business complying with the ESG standards. This happened in conjunction with the shaping of a set of generally accepted principles for sustainability accounting, and the increasing regulatory compliance with respect to these standards. Chapter II covers the institutional framework of the capital market and the underlying regulations that made possible the integration of ESG into the financial system on a lasting and material basis. This includes the evolution of ESG ratings and benchmarks, as well as the regulatory codification of sustainability achieved via the Sustainable Finance Disclosure Regulation (SFDR), the EU Taxonomy and the Corporate Sustainability Reporting Directive (CSRD). ESG has gradually evolved into a system of market discipline that translates environmental and social concerns into risk prices and investment decisions. Chapter III moves the analysis to the level of the firm and studies firm reactions towards the financialized ESG policy constraint. This part of the book analyses the opportunities and constraints that the metric-based sustainability regime of the financialized ESG imposes on firms. While it is assumed that the financialized ESG increases the transparency of firms and motivates them to manage long term risks, the metrics and benchmarks that are the foundation of the financialized ESG also contain numerous distortions, short term focuses and homogenisation effects. This analysis is the groundwork for the discussion in Chapter IV about competitive sustainability as an evolutionary exit to the financialized ESG discourse. In short, competitive sustainability is about the strategic integration of environmental and social elements in firm-specific assets, long-term capital structures, governance and industry positions. This thesis does not say that ESG per se is a bad thing; it is rather a matter of moving away from the current metric-driven version of ESG and considering the integration of sustainability into the competitive advantage logics of firms. The normative claim advanced is that firms ought to treat ESG alignment as a baseline condition of legitimacy and market participation, while preserving strategic agency to pursue differentiated, long-term sustainability pathways. By reconciling external accountability with internal strategic design, the thesis contributes to the broader debate on the future of sustainable capitalism and the evolving role of corporations within complex socio-economic systems.

2. Chapter I - The Transformation of Corporate Responsibility: From Normative Foundations to Financial Materiality

2.1 Origins and Early Evolution of CSR: Corporate Purpose as a Normative Question

The origins of Corporate Social Responsibility (CSR) are tied to the historical development of the corporation and its transformation from a relatively narrow economic institution to a powerful social institution. In the early twentieth century, the meteoric rise of large publicly held corporations and the increasing separation of ownership and control from management raised questions about the limits of corporate power. As corporations became the dominant organizational form for large-scale production, employment, capital, and wealth generation, their decisions began to affect the social and political structure of societies as a whole. It was within this changing social and economic context that scholars and policymakers started to ask: who should be responsible for ensuring that corporations served the public interest? The question reached a point of articulation in what would later be known as the "corporate purpose debate," particularly the exchange between Adolf Berle and Merrick Dodd in the 1930s concerning whether managers had a duty to serve only shareholders or also the broader social interests of the communities in which the corporations operated[1].

At its core, this question raised a broader, more fundamental question about the place of corporations within the social structure of societies. If corporations were merely private contractual relationships between investors, there would be little basis for arguing that managers had a duty to anyone other than shareholders. However, if corporations were thought of as semi-public institutions with considerable power over society, their legitimacy would depend on how well they accounted for the interests of various stakeholders beyond shareholders, such as employees, consumers, and community members. It is now increasingly acknowledged by contemporary scholars that this question was never definitively resolved and has implications for corporate governance today. Thus, the origins of CSR should not be viewed as the emergence of a new conceptual field of study or framework for evaluating corporate performance. Rather, it is a concept that arose from the recognition of the unresolved question of the proper limits of corporate power in societies[2]. The controversy over corporate purpose was not merely a technical question of fiduciary obligations, but a concern about the legitimacy of concentrations of economic power in democratic societies. As corporations became increasingly large and powerful, they began to assume many of the functions of public authorities, with the ability to shape the conditions of employment, development in communities, and the environment. But the growth in corporate power created a potential legitimacy gap, since corporations were acting with quasi-public authority, but their internal governance structure was not subject to direct democratic

[1] A. A. Berle, "Corporate Powers as Powers in Trust", Harvard Law Review, 1931; E. M. Dodd, "For Whom Are Corporate Managers Trustees?", Harvard Law Review, 1932.
[2] J. Bakan, The Corporation: The Pathological Pursuit of Profit and Power, Free Press, 2004; S. B. Banerjee, Corporate Social Responsibility: The Good, the Bad and the Ugly, Edward Elgar Publishing, 2007.

control. Thus, early CSR thought may be seen as an attempt to establish a kind of "social contract" that would legitimate business's claim to exercise a certain amount of power over society[3].

Under the banner of this social contract framework, corporations were granted special privileges in return for playing a positive role in the welfare and development of society. In other words, CSR can be understood as an effort to reconstitute the relationship between business's autonomy to operate independently and its social responsibilities. Thus, CSR was not simply a question of management's optional philanthropic efforts; it involved an attempt to align private enterprise with public values. As with the implicit social contract framework, the rationale underlying this one is that corporations would remain able to secure trust and support from society only if they demonstrated an awareness of their social responsibilities. If they failed in this respect, they would likely incur public backlash or regulatory reactions that would reinforce the relationship between voluntary gestures and legally-mandated obligations. More systematic debates about the social responsibilities of business arose in the mid-20th century, when authors began formulating theories of the social role of firms and corporations. An important contribution to the literature emerged in 1953 with the publication of Howard R. Bowen's book The Social Responsibilities of the Businessman, which is now considered one of the central texts in the CSR literature[4]. In the book, Bowen asked what obligations businessmen have to act in socially responsible ways, and he concluded that social responsibility can be defined as the obligation to act in ways that promote policies and decisions that are desirable in accordance with the goals and values of society. Thus, while earlier texts had raised questions about corporate purpose and operation, Bowen's contribution introduced a new lens through which to view corporate conduct.

Yet Bowen's specific argument did not deny the economic function of the firm. Rather, it acknowledged that corporations do operate in a social environment that legitimizes and enables them, and that this legitimacy confers obligations. By situating managerial decisions in a value system, rather than in a system of rules, Bowen framed corporate responsibility as an ethical exploration of the proper role of business in society[5]. Thus, CSR was seen, in its early stages, as an ethical orientation rather than a system of obligations or a set of performance indicators. It aimed to reconcile the growing power of corporations with the expectations of a democratic society, emphasizing that commercial power must be used in a way that enhances social welfare. This early conception of CSR would shape all subsequent theories, although its normative arguments would be challenged.

Yet as the field of CSR began to take shape, its theorists sought to make its concepts more precise and its theories more robust in ways that would enable it to address the tension between the obligation to serve shareholders and obligations to the public at large. Stakeholder theory would emerge as the most influential theory in this effort[6]. Stakeholder theory conceptualizes the firm not only as a web of contracts that binds its managers and employees to its shareholders, but as a complex network of

[3] S. B. Banerjee, Corporate Social Responsibility: The Good, the Bad and the Ugly, Edward Elgar Publishing, 2007; R. Shamir, "The Age of Responsibilization: On Market-Embedded Morality", Economy and Society, 2008.
[4] H. R. Bowen, Social Responsibilities of the Businessman, Harper & Row, 1953.
[5] D. Matten, J. Moon, "Implicit and Explicit CSR: A Conceptual Framework for Understanding CSR in Europe", Academy of Management Review, 2008.
[6] R. E. Freeman, Strategic Management: A Stakeholder Approach, Pitman, 1984.

relationships that involves employees, suppliers, customers, and other groups that are affected by its activities. Managers have an obligation to take these stakeholders into account[7].

Yet stakeholder theory itself has taken on several forms. Scholars have distinguished between normative, descriptive, and instrumental approaches to stakeholder management. The normative approach contends that stakeholders have inherent moral claims on the firm, regardless of their contribution to its financial performance. The descriptive approach seeks to understand how firms actually operate in complex networks of relationships. The instrumental approach explores whether managing stakeholders can improve the performance of firms[8]. These different approaches demonstrate that CSR was never a monolithic concept, but a field of study with many open questions.

The coexistence of these different approaches would have significant implications. The normative approach would retain its ties to the earlier moral theories of CSR, while the instrumental approach would be more compatible with the theory that links stakeholder management to enhanced financial performance. In this sense, the development of CSR theories mirrored the development of other theories about corporate governance in the 1980s: ethical arguments were redefined in terms of efficiency.

Yet the lack of conceptual clarity within stakeholder theory would also have implications for later developments in the field of CSR. For example, it would contribute to demands for clearer definitions of CSR, more accurate metrics for measuring its effectiveness, and more robust frameworks for comparing the effectiveness of firms that claim to manage their social responsibilities.

The development of CSR theories in the 1960s and 1970s took place against the backdrop of a rapidly expanding modern regulatory state. In response to growing public concerns about the negative impacts that corporations could have on the environment, working conditions, and consumers, governments enacted a wide range of laws governing pollution, workplace safety, consumer protection, and other issues. As society intervened in the operations of firms in so many ways, it raised questions about whether voluntary efforts by corporations to manage their social responsibilities would serve as an effective substitute for regulation, or whether it would be better to place such obligations within a regulatory framework[9]. Thus, CSR was seen from its earliest days as a potential space for negotiation between moral aspirations and institutional imperatives. Yet surprisingly little attention was devoted in early CSR studies to the question of the proper goal or objective of corporations. The purpose debate, which emerged years later, would raise fundamental questions about whether firms' goals: whether their primary purpose was to serve the interests of their shareholders, or whether they had a broader goal that related more closely to the welfare of society as a whole[10]. Thus, despite its normative focus, the early scholarship on CSR was not very prescriptive.

[7] R. E. Freeman, Strategic Management: A Stakeholder Approach, cit.; R. E. Freeman et al., Stakeholder Theory: The State of the Art, Cambridge University Press, 2010.
[8] T. Donaldson, L. E. Preston, "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications", Academy of Management Review, 1995.
[9] J. L. Campbell, "Institutional Analysis and the Paradox of Corporate Social Responsibility", American Behavioral Scientist, 2006; D. Matten, J. Moon, "Implicit and Explicit CSR: A Conceptual Framework for Understanding CSR in Europe", Academy of Management Review, 2008.
[10] L. A. Bebchuk, R. Tallarita, "The Illusory Promise of Stakeholder Governance", Cornell Law Review, 2020.

This question would be raised again in the face of a powerful counter-narrative about the role and objectives of corporations. This narrative would rely on economic theories and concepts that would reshape the study of corporate responsibility in ways that would force CSR theorists to rethink their ideas in terms that were more familiar to business academics, and would ultimately lead to a transformation of CSR that would be difficult to recognize as the same theory.

2.2 The Rise of Shareholder Primacy and CSR's Strategic Adaptation

The normative foundations of early CSR scholarship were almost at once confronted with a strong counter-argument, one based in economic and legal theory. In the late twentieth century, in particular, the doctrine of what has come to be known as "shareholder primacy" gained the upper hand in the United States. Its most authoritative formulation was provided by Milton Friedman, who asserted that "the only social responsibility of business is taken to be to use the resources of business, and pursue an course of action, as efficiently as possible, in ways consistent with the law"[11]. In this view, the role of corporate managers is to act on behalf of shareholders, and the only duties owed to other parties are those owed under law to regulating their actions. The diversion of resources away from profit maximization for other social purposes would accordingly be seen as an illegitimate use of someone else's money.

The argument from shareholder primacy reconfigured the debate over corporate responsibility in several respects. Rather than disputing whether corporations owe a moral duty to society, this position holds that if social welfare is to be promoted, it can only be done effectively through markets and political institutions rather than through discretionary actions taken by corporate managers. By shifting the locus of social responsibility from managers to laws and policies established by governments or regulatory bodies, this argument does not preclude a concern with the impact of corporations; it merely reconfigures the question of how this concern is to be addressed. Yet the intellectual power of the argument from shareholder primacy derives from much more than Friedman's claim about what managers owe to those on whose behalf they act. It has been reinforced by developments in economic theory as well as in scholarship on law and corporations. Agency theory, for example, has provided a theoretical basis for the view that the scope for managerial discretion should be limited, and that executives' incentives should be structured in ways that reflect their responsibilities to shareholders rather than other interests[12]. If managers are seen as agents of dispersed shareholders with competing interests, the potential costs of allowing them to pursue goals other than profit maximization increases. It becomes more likely that the time and resources spent on these goals will yield returns of little value to shareholders, and thus less likely that shareholders will be able to secure the performance they expect from corporate managers. The stress on efficiency, market discipline and contractual governance all serve to underwrite the argument that the scope of corporate goals should remain narrow.

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[11] M. Friedman, "The Social Responsibility of Business is to Increase its Profits", The New York Times Magazine, 13 September 1970.
[12] M. C. Jensen, W. H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", Journal of Financial Economics, 1976.

In parallel, influential corporate law doctrinal scholars claimed that a consensus had formed around the idea that shareholder value was the unifying principle for corporate governance[13]. The concentration of residual control rights in shareholders was said to reduce monitoring costs and maximize the allocative efficiency of capital markets. Social and environmental objectives, while arguably desirable, were said to merit regulation in the public rather than the private sphere. Thus, this theoretical framework did not merely reject CSR; it regarded it as either superfluous if markets and regulation are effective, or dangerous if it increases managers' discretionary latitude without enhancing their accountability. Thus, CSR faced the challenge of explaining its necessity in a governance framework that was increasingly focused on financial performance and measurable results. Despite the rise in the ideological dominance of shareholder primacy, however, CSR did not disappear from academic or corporate discourse. Rather than stagnating, it evolved in response to the challenge posed by economic orthodoxy. During its development in the late twentieth century, CSR scholarship became increasingly empirical in its focus, examining issues such as corporate disclosures, executive attitudes, and the relationship between socially responsible conduct and financial performance[14]. Corporations began to adopt voluntary practices such as codes of conduct, sustainability reports, and self-regulatory initiatives based on standards developed by nongovernmental organizations and international bodies. These developments suggest that rather than disappearing as a result of the rise of shareholder primacy, CSR was reconfigured in such a way that it could be accommodated within the parameters of a market-based governance framework.

Yet the terms of the debate shifted from a question of whether corporations should engage in socially responsible conduct to whether there is an anachronistic "business case" for doing so. This shift in language was a clear sign that the debate was being reframed: social responsibility was no longer to be justified on moral or ethical grounds, but in terms of its contribution to the creation of value, reputation, and risk management[15]. To the extent that it linked responsible conduct to these tangible benefits, the business case for CSR effectively incorporated various stakeholder concerns into the logic of shareholder value that dominated corporate governance frameworks. In doing so, thus, CSR shifted away from its earlier normative conception toward a more instrumental and strategically integrated view of managerial responsibility.

As the language of shareholder value became increasingly dominant in corporate governance debates, thus, the concept of CSR began to be redefined in terms of its strategic and financial advantages. Rather than using social responsibility as an alternative to profit maximization, scholars and practitioners emphasized its positive contribution to profit performance. This shift in perspective was reflected in increasing attention paid in the academic literature to issues such as corporate sustainability, reputational capital, and risk management as areas in which CSR could contribute to shaping business strategies in ways that would enhance their economic performance within market

[13] N. Fligstein, T. J. Shin, "Shareholder Value and the Transformation of the U.S. Economy, 1984–2000", Sociological Forum, 2007; G. R. Krippner, "The Financialization of the American Economy", Socio-Economic Review, 2005.
[14] A. B. Carroll, "The Pyramid of Corporate Social Responsibility", Business Horizons, 1991; D. Matten, J. Moon, "Implicit and Explicit CSR", Academy of Management Review, 2008.
[15] M. E. Porter, M. R. Kramer, "Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility", Harvard Business Review, 2006; M. E. Porter, M. R. Kramer, "Creating Shared Value", Harvard Business Review, 2011.

frameworks[16]. The shift in itself represented a profound transformation in the logic of corporate responsibility. While earlier CSR scholarship had underscored the a priori ethical and societal mandates for responsible conduct, the more recent trends in the field have stressed instead the potential benefits to stakeholders, management efficiency, operations, and even regulatory and litigation risks. Responsibility was thus redefined not only as an ethical imperative, but as a necessity that could be evaluated and optimally managed. The center of gravity of the concept thus shifted from "what corporations owe to society" to "how societal and environmental factors affect firms." Although this shift did not eliminate all normative concerns, it did situate them within a framework that was oriented toward promoting the long-term interests of responsible managers. It was within this context of strategic concerns that subsequent developments in the discourse of corporate responsibility would unfold.

The trend toward the "business case" for CSR was consistent with a larger transformation in corporate value creation. As developed economies have shifted toward knowledge-based and service sectors, intangible assets have become increasingly important to their performance. Intangible assets such as brand reputation, organizational culture, human capital, and stakeholder relationships have emerged as key assets[17]. Thus, socially responsible conduct can be viewed as a means of investing in these assets, which can enhance a firm's long-term sustainability and competitive advantages. Companies that excel at managing environmental and social risks are seen as better able to avoid costly litigation, regulatory penalties, or damage to their customer base. Thus, CSR has increasingly been incorporated into corporate risk management strategies. As these trends unfolded, researchers have also sought to explore empirically the links between corporate social performance and financial performance, in the hope of determining whether socially responsible conduct can yield a positive financial return to investors. While some studies have suggested a positive link, others have found none, or mixed evidence, raising questions about the limits of measurement and the search for causal links[18]. The ambiguous results of such studies have not, however, undermined the strategic rationale for integrating CSR concerns into corporate decision-making. If anything, they have reinforced the search for more reliable measures, standardized disclosure practices, and methods for integrating nonfinancial performance indicators into financial analyses. In this sense, the emphasis on instrumental benefits has fueled the trend toward quantification and comparability.

[16] R. G. Eccles, I. Ioannou, G. Serafeim, "The Impact of Corporate Sustainability on Organizational Processes and Performance", Management Science, 2014.
[17] J. Barney, "Firm Resources and Sustained Competitive Advantage", Journal of Management, 1991; S. L. Hart, "A Natural-Resource-Based View of the Firm", Academy of Management Review, 1995.
[18] G. Friede, T. Busch, A. Bassen, "ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies", Journal of Sustainable Finance & Investment, 2015; J. Surroca, J. A. Tribó, S. Waddock, "Corporate Responsibility and Financial Performance: The Role of Intangible Resources", Strategic Management Journal, 2010.

2.3 From CSR to ESG: The Emergence of a Measurable Framework

By the early 21st century, the diffuse and strategically adapted world of CSR had developed a complex, fragmented landscape of meanings, practices, and voluntary standards. CSR had long since embraced the language of long-term value creation and sustainable competitiveness. Yet its boundaries remained contested, its practice heterogeneous[19].

Companies' approaches to sustainability reporting varied widely. Nongovernmental organizations (NGOs) spawned a plethora of competing guidelines. Scholars offered a wide range of definitions of what responsible corporate conduct should entail. All this signified dynamism, but also a degree of ambiguity. In the absence of anything like universally accepted benchmarks, it became difficult for investors and regulators to evaluate and compare the social and environmental performances of companies[20]. Thus calls for greater clarity, measurability, and integration into financial analysis became increasingly common. It was in this context that the concept of Environmental, Social, and Governance (ESG) started to gain traction. Although environmental and social factors had long been an established component of socially responsible investment (SRI) practices, the concept of ESG as a cohesive analytical framework was formally defined for the first time in the 2004 report Who Cares Wins, commissioned by the United Nations Global Compact[21]. The aim of the initiative was to encourage financial markets to start to take environmental, social, and governance issues seriously and to incorporate them into mainstream investment practices and processes, such as valuation and risk assessment. The architects of the ESG initiative deliberately avoided using any references to CSR or its variants. Their intention was to present the new framework as a pragmatic and relevant approach that would resonate with investors and asset managers. Yet despite its frequent claim to be the offspring of CSR, the real story of how ESG came into being is more complex. Contemporary scholarship emphasizes that the concept of ESG does not signify a single or monolithic approach[22]. It encompasses a range of potentially inconsistent interpretations. In some cases it is regarded as a sustainability-oriented investment philosophy with an avowed objective of enhancing long-term prosperity for all concerned. More often, however, it is viewed as a vehicle for identifying financial risks; an effective tool for pinpointing factors that may affect a company's future prospects. Finally, ESG is often regarded primarily as a disclosure framework or architecture: that is, something that seeks above all to increase transparency and comparability among companies, rather than anything that ties firms to specific ethical or behavioral commitments.

These different interpretations all reflect the hybrid origins of the concept of ESG at the nexus of sustainability concerns, financial economics, and corporate governance reform agendas. One of the important innovations embodied in the concept of ESG is its reliance on the concept of materiality as the defining framework for analyzing environmental, social, and governance issues[23]. Within financial markets, materiality is defined simply as information that could affect the decisions of a reasonable investor. The translation of these concerns into ESG factors thus allows practitioners to

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[19] D. Matten, J. Moon, "Implicit and Explicit CSR", Academy of Management Review, 2008; M. Blowfield, A. Murray, Corporate Responsibility: A Critical Introduction, Oxford University Press, 2008.
[20] S. L. Gillan, A. Koch, L. T. Starks, "Firms and Social Responsibility: A Review of ESG and CSR Research in Corporate Finance", Journal of Corporate Finance, 2021.
[21] United Nations Global Compact, Who Cares Wins: Connecting Financial Markets to a Changing World, 2004.
[22] E. Pollman, "The Making and Meaning of ESG", University of Pennsylvania Law Review, 2022.
[23] E. Pollman, "The Making and Meaning of ESG", University of Pennsylvania Law Review, 2022.

analyze environmental, social and governance issues through the same analytical lens that financial theorists use to examine factors affecting corporate performance. This transformation of the normative framework governing corporate responsibility does offer a measure of clarity and utility. Materiality-based frameworks can facilitate the identification of specific responsibilities while also increasing comparability among firms, and allowing for the integration of ESG factors into established governance and value-measurement frameworks. But it also poses limitations. The constraints imposed by a materiality framework by definition marginalize issues that cannot be quantified or expressed in terms of their potential contribution to financial value[24]. An increasing body of research findings suggests that integrating ESG factors into investment decisions does not produce noticeable benefits to investors; at best it may enhance companies' reputation or sustainability performance[25].

Despite such ambivalent empirical findings, however, the institutionalization of ESG reporting, rating and benchmarking practices has achieved impressive and largely uncontested progress over recent decades[26].

The cumulative effect of these developments was a subtle yet transformational reconfiguration of the architecture of corporate responsibility. Where strategic CSR had sought to find a space of overlap between ethical constraints and business advantages, ESG made social and environmental concerns the very stuff of the metrics that governed access to finance and capital allocation. Responsibility was thus re-articulated in terms of metrics, scores and standardized regimes of disclosure that rendered firms comparable to one another on a range of criteria. The gains in visibility and investor engagement that this development brought about, however, also marked a certain metricization and institutionalization of corporate responsibility within the structures of the market itself. The implications of this development for corporate strategy, governance, and the evolving relationship between business and society, however, will have to be explored in the chapters that follow. The cumulative effect of these developments was not only procedural in nature, however. Where strategic CSR had sought to find a space of overlap between ethical constraints and business advantages, ESG made social and environmental concerns the very stuff of the metrics that governed access to finance and capital allocation. Responsibility was thus re-articulated in terms of metrics, scores and standardized regimes of disclosure that rendered firms comparable to one another on a range of criteria. While the increases in visibility and investor engagement enabled by this development may be considerable, however, it is not clear whether this new framework for corporate social responsibility does expand or limit the scope of corporate accountability, given its grounding in concerns that are relevant and visible to investors. The implications of this development for corporate strategy, governance, and the evolving relationship between business and society, however, will have to be explored in the chapters that follow.

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[24] C. Mayer, "Valuing the Invaluable: How Much is the Planet Worth?", Oxford Review of Economic Policy, 2019; A. Damodaran, "Sounding Good or Doing Good? A Skeptical Look at ESG", 2020.
[25] P. Krüger, "Corporate Goodness and Shareholder Wealth", Journal of Financial Economics, 2015; G. Friede, T. Busch, A. Bassen, "ESG and Financial Performance", Journal of Sustainable Finance & Investment, 2015; A. Edmans, "The End of ESG", Financial Management, 2022.
[26] F. Berg, J. Koelbel, R. Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings", Review of Finance, 2022; D. M. Christensen, G. Serafeim, A. Sikochi, "Why Is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings", The Accounting Review, 2022

The historical and conceptual exploration of this chapter has shown that corporate responsibility has always been an evolving and adaptive concept, formulated within varying institutional and economic contexts. It arose as a moral imperative in response to the rising power of modern corporations, formulated in terms of arguments about legitimacy and duty. Its reconfiguration in response to the rise of shareholder primacy took place within a framework of argumentation that rearticulated it in terms of (long-term) business value. The concept of ESG, however, has once again changed its object: by making social, environmental and governance concerns integral to a concept of financial materiality, it has reconfigured the operational meaning of corporate responsibility. The effects of this change have undoubtedly rendered its application more standardized, comparable and integrated into the structures of financial markets. Yet in doing so, however, it raises a fundamental question: when responsibility is primarily concerned with its financial implications, does this create new avenues for making corporations accountable for their social and environmental impacts? Or does it merely constrain their accountability to the evaluation frameworks of investors? The next chapters will grapple with these questions in depth, initially focusing on how ESG has reconfigured corporate strategies before considering whether it can be regarded as a proper conceptual framework for addressing concerns about long-term value creation in an ethical manner.

3. **CHAPTER II - The Institutionalization and Financialization of ESG**

3.1 ESG as Market Infrastructure

The transformation that occurs with the redefinition of ESG in terms of financial materiality and investor relevance does not stop at the conceptual level. With the repositioning of core concerns of sustainability at center of the operating model that underlies the functioning of capital markets, ESG transforms from a framework that informs managerial deliberation to an operational infrastructure[27]. Yet the institutionalization of the ESG framework and its conversion into an operational infrastructure for capital markets is the work of a multiplicity of actors: asset managers, institutional investors, credit rating agencies, index providers, data analytics companies, and even regulatory authorities. The actors involved are all engaged in processes that involve the integration of the concerns that inform the ESG framework into the benchmarking models that guide asset allocation, the design of indexes and other investment vehicles, and even the "valuation" models that inform the relative attractiveness of investment vehicles to institutional investors[28]. In this sense, it can be argued that the limits of the ESG framework have expanded to encompass a set of information norms that structure capital market actors in predictable ways, with less resemblance to a set of voluntary ethical commitments to which firms can choose to adhere[29].

An especially important mechanism through which this institutionalization of the ESG framework has occurred is the emergence of ESG ratings and scoring systems. Rating agencies assess firms with respect to their E, G, and S performance and assign composite ratings that allow investors to make valid comparisons between the sustainability performance of different types of firms. Institutional investors rely heavily on these ratings to scan their portfolios for investments that do not meet their ESG criteria, design financial products that allow investors to track indexes with specified ESG features, and satisfy any legal obligations that they may have to promote the ESG concerns of the investors whose assets they manage[30]. Yet as has been reported in previous research, significant discrepancies exist between rating agencies in the choice of indicators, the methods of weighting, and interpretations that can lead to very different views of firm performance on the part of different stakeholders[31]. The current state of affairs with respect to the objectivity of these ratings contrasts with the high objectivity of the credit ratings that are produced by traditional rating agencies, raising new questions about their reliability and legitimacy. Despite these limitations, however, ESG ratings have a significant impact on investors who rely on them to inform their decision-making processes. A large number of asset managers are now using ESG metrics to inform their investment processes, not only because their clients have expressed a demand for sustainability concerns to be taken into

[27] E. Pollman, "The Making and Meaning of ESG", University of Pennsylvania Law Review, 2022
[28] G. Giese, L. E. Lee, D. Melas, Z. Nagy, L. Nishikawa, "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance", The Journal of Portfolio Management, 2019; S. L. Gillan, A. Koch, L. T. Starks, "Firms and Social Responsibility", Journal of Corporate Finance, 2021.
[29] G. A. Epstein (ed.), Financialization and the World Economy, Edward Elgar Publishing, 2005; G. R. Krippner, "The Financialization of the American Economy", Socio-Economic Review, 2005.
[30] S. Kotsantonis, C. Pinney, G. Serafeim, "ESG Integration in Investment Management: Myths and Realities", Journal of Applied Corporate Finance, 2016.
[31] F. Berg, J. Koelbel, R. Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings", Review of Finance, 2022; D. M. Christensen, G. Serafeim, A. Sikochi, "Why Is Corporate Virtue in the Eye of the Beholder?", The Accounting Review, 2022.

account, but also because the factors contributing to failures in ESG performance can be major sources of systemic risk, (e.g. climate-related risks, supply chain disruptions, governance failures, and reputational shocks)[32]. These factors are now being incorporated into models that guide capital allocations and create incentives for firms that fail to keep pace with developments in ESG performance metrics. For instance, firms that fail to achieve acceptable levels of ESG performance may experience premium costs for capital, or they may be denied access to institutional investors whose mandates require investments to achieve specified ESG goals. Thus, firms can no longer ignore concerns related to ESG; they become "responsible" because failure to comply with emerging norms for ESG metrics creates financial consequences.

Thus, rather than seen as an optional framework that can be applied to governance practices, the institutionalization of the ESG framework alters the relationship between corporate governance and capital markets in such a way that non-financial sustainability factors play a role in determining how firms can sustain access to affordable capital, and thus achieve their financial objectives[33]. In this new environment, questions about corporate governance affect processes that extend beyond the boardroom; they may influence processes that affect costs of capital, risk management strategies, incentives for executives, and even the more traditional concerns that dominate discussions of corporate governance in governance practices that inform boardroom deliberations. The remit of sustainability practitioners and other stakeholders who seek to promote the development of firms along sustainable paths may be expanding to a realm in which such factors are woven into the fabric of how firms are governed, at the level of their operations, rather than treated as an optional set of practices or constraints that can be managed in relative isolation from the "core" operational practices of the firm.

In exploring the next steps in this institutionalization of the ESG framework, it is unclear whether its impact on corporate governance will ultimately enhance the performance of firms over time (i.e., increase their ability to achieve their goals), or whether it will merely impose limits on practices that firms may pursue without encroaching on sustainability concerns that investors deem relevant. The rise of ESG ratings has been one of the key mechanisms for institutionalizing sustainability into financial markets. Rating agencies and data providers compile and synthesize vast amounts of information about corporations' environmental impacts, labor practices, governance frameworks, supply chain management, and risk exposures. Applying their proprietary methodologies to these datasets yields scores that facilitate comparison across firms. In doing so, the ratings construct transform qualitative, multifaceted concepts of corporate conduct into numerical values that can be incorporated into financial evaluation processes. Yet this transformation is not innocuous. The methodological approaches of ESG rating agencies exhibit significant variations in their choice of indicators, weighting, treatment of controversies, and reliance on self-reported versus externally verified data. Research has uncovered astonishingly low correlations across the major ESG rating providers; in contrast, the variance in credit ratings displaying similar levels of consistency is much

[32] G. Giese et al., "Foundations of ESG Investing", The Journal of Portfolio Management, 2019; G. Friede, T. Busch, A. Bassen, "ESG and Financial Performance", Journal of Sustainable Finance & Investment, 2015.
[33] S. L. Gillan, A. Koch, L. T. Starks, "Firms and Social Responsibility", Journal of Corporate Finance, 2021.

higher[34]. Such findings suggest that ESG scores are not objective measures of sustainability performance but rather a constructed representation of a firm's conduct that reflects its adherence to the preferred features of sustainability metrics.

The implications of rating disparities extend beyond the realm of academic discourse. The scores still exert considerable influence over which firms investors select for inclusion in portfolios, or whose assets are eligible for impact investing indexes, or whose assets are directed toward specific thematic funding vehicles. A firm that one rating provider classifies as a sustainability leader may be regarded as merely adequate by another, which could affect its accessibility to investors and its market positioning. The current lack of harmonized standards for ESG rating agencies thereby creates informational uncertainty around a mechanism that purports to provide transparency and comparability. Yet the very construction of these ratings also creates a powerful incentive for firms to behave in an environmentally responsible manner. Firms now manage their ESG performance with explicit reference to rating criteria, adjusting their disclosure practices, governance structure, and operational behaviors to enhance their scores as highly as possible. In this regard, ratings do not merely measure corporate sustainability; they produce it as well. Corporate responsibility becomes in part defined by the metric that is used to evaluate it, highlighting how the quantifiable aspects of social performance tend to dominate (or at least receive equivalent attention) to its nonquantifiable aspects[35]. The increasing reliance on ESG ratings, therefore, reflects a broader transformation: responsibility is rendered legible to markets through metricization. Yet metricization implies simplification. Complex social and environmental realities are distilled into composite scores that may obscure context and trade-offs. As critics have pointed out, such frameworks risk prioritizing what can be measured over what should matter. This conundrum of comparability versus conceptual richness is the engine of ESG's institutionalization.

In short, ESG ratings exemplify the financialization of corporate responsibility. By translating sustainability attributes into standardized data that are incorporated into models of financial performance, ratings embed ethical and governance considerations within the structure of market evaluation. The question of whether ratings do affect markets (and they clearly do) is of secondary interest. More important is how their influence reconfigures firms' incentives, investors' behaviors, and what can be understood as accountability.

Beyond ratings, however, ESG has also spawned an industry of sustainability-oriented benchmarks issued by index providers. These firms now offer a wide range of ESG-screened, best-in-class, and low-carbon indices that identify firms whose practices meet specific sustainability criteria[36]. These benchmarks are no mere technical innovation. They are a resource that a rapidly growing segment of investors relies on to guide their investment decisions: passive investment products, such as exchange-traded funds (ETFs) and index funds. The proliferation of ESG benchmarks constitutes a significant institutionalization of ESG concerns. When sustainability criteria are factored into the design of widely followed indices, capital flows are reoriented according to the mechanics of passive

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[34] F. Berg, J. Koelbel, R. Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings", Review of Finance, 2022; D. M. Christensen, G. Serafeim, A. Sikochi, "Why Is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings", The Accounting Review, 2022.
[35] R. Shamir, "The Age of Responsibilization: On Market-Embedded Morality", Economy and Society, 2008.
[36] R. Sullivan, C. Mackenzie (eds.), Responsible Investment: Guide to ESG Data Providers and Relevant Trends, Routledge, 2017.

investing. The composition of these indices is replicated by ETFs and index-linked funds. The inclusion in, or exclusion from, major ESG benchmarks has significant implications for corporate governance. The firms that are included in prominent ESG indices have incentives to adjust their disclosure practices and operational behaviors accordingly. The firms that are excluded from the most prominent indices may incur reputational costs or even suffer relative losses in market performance due to the heightened visibility of their "governance risks." The relevance of sustainability performance thus becomes inescapably financial. The embedding of ESG criteria within index construction also manifests the transition from voluntary ethical conduct to a binding framework of finance. When sustainability filters are codified in the methodology of an index, it enters the domain of automated capital allocation systems. Responsibility is thus translated into algorithmic inclusion or exclusion, illustrating how ESG has shifted from narrative CSR discourse to a structured market infrastructure.

The institutionalization of ESG would not have been possible without the role of large asset managers and institutional investors. Over the last decade, pension funds, sovereign wealth funds, insurance companies, and global asset management firms have increasingly integrated ESG considerations into their investment processes[37]. This has been prompted by a variety of factors, including positive feedback from clients, reputational concerns, evolving regulations, and growing awareness of sustainability-related systemic risks. ESG integration can take various forms. Some investors apply exclusionary screens that avoid investing in certain sectors, such as fossil fuels or controversial weapons. Others follow a best-in-class approach that seeks to invest in firms that perform relatively well on ESG factors in comparison to their sector peers. Yet others embed ESG factors into their valuation models and portfolio optimization frameworks, adjusting expected cash flows, discount rates or risk premia for sustainability-related exposures[38].

The financial logic of these approaches is related to the discussion on the link between ESG performance and financial performance. Proponents argue that better-performing firms on ESG factors reduce regulatory risks, avoid reputational damage, enhance operational performance and reduce the cost of capital[39]. Detractors argue that the available empirical evidence is not yet sufficient, and that ESG integration can create trade-offs depending on market conditions[40]. Irrespective of whether causality runs from financial performance to ESG performance or vice versa, however, the critical structural shift is that ESG factors have entered mainstream investment analysis rather than being confined to niche socially responsible investment (SRI) practices.

Corporate managers now encounter ESG as a critical aspect of investor relations and access to capital rather than merely a reputational consideration. Institutional investors' engagement initiatives often

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[37] G. Giese et al., "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance", The Journal of Portfolio Management, 2019; S. Kotsantonis, C. Pinney, G. Serafeim, "ESG Integration in Investment Management: Myths and Realities", Journal of Applied Corporate Finance, 2016.

[38] S. Kotsantonis, C. Pinney, G. Serafeim, "ESG Integration in Investment Management: Myths and Realities", Journal of Applied Corporate Finance, 2016; R. Sullivan, C. Mackenzie (eds.), Responsible Investment, Routledge, 2017.

[39] S. El Ghoul, O. Guedhami, C. C. Y. Kwok, D. R. Mishra, "Does Corporate Social Responsibility Affect the Cost of Capital?", Journal of Banking & Finance, 2011; G. Friede, T. Busch, A. Bassen, "ESG and Financial Performance", Journal of Sustainable Finance & Investment, 2015.

[40] P. Krüger, "Corporate Goodness and Shareholder Wealth", Journal of Financial Economics, 2015; C. Revelli, J. L. Viviani, "Financial Performance of Socially Responsible Investing (SRI): A Meta-Analysis", Business Ethics: A European Review, 2015.

target board composition, executive compensation alignment, climate transition planning and disclosure standards[41]. In this sense, ESG functions as a mechanism for investors to exert influence over corporate governance while expanding the boundaries of traditional shareholder oversight. The growth in ESG ratings, benchmarks and investor integration practices demonstrates that ESG has become a systemic element of contemporary capital markets. The structure of data providers, index designers, portfolio managers and regulatory frameworks that support ESG creates a feedback loop between measurement and market behavior. Corporate responsibility is no longer assessed through moral arguments or dialogue with stakeholders, but through financially material indicators embedded in investment processes.

3.2 Regulation as Institutional Response

The shift toward private ESG ratings, benchmarks and data providers has created a paradox. The increased visibility of sustainability factors in financial markets has exposed the weakness of the underlying structure. Inconsistencies, lack of transparency, varying data quality and the potential for greenwashing all contribute to the problem of comparability and accountability. As sustainability metrics became increasingly entrenched in capital allocation processes, it was natural to ask who was setting the sustainability standards and on what normative assumptions they were based.

In this context, regulation can be seen as a response to fragmentation; the absence of common disclosure standards created information asymmetries between companies and investors, while the proliferation of voluntary sustainability reporting frameworks encouraged companies to pick and choose what they wanted to report. When sustainability metrics came into play as factors affecting market prices, risk assessments and portfolio construction, the question of which ESG data or report to rely on became a matter of concern. The regulation of ESG is therefore a second wave of institutionalization that is reversing the trend toward self-regulation. The main actors in ESG reporting—corporations and rating agencies—face a range of measures aimed at standardizing ESG disclosure frameworks, sustainability classification systems and transparency requirements. The European Union is at the forefront of efforts to transform what was an incoherent patchwork of voluntary sustainability disclosure practices into a comprehensive framework regulating sustainability disclosures that must be transparent and comparable.

The next sections of this chapter will examine the various pillars of this emerging regulatory architecture in turn, focusing on their implications for corporate disclosures, investment decisions and capital allocation.

The first pillar of the European regulatory architecture concerns corporate-level disclosure obligations. The adoption of Directive 2014/95/EU, commonly referred to as the Non-Financial Reporting Directive (NFRD), represents a major step in the institutionalization of environmental and

[41] J. Grewal, G. Serafeim, A. Yoon, “Shareholder Activism on Sustainability Issues”, Journal of Business Ethics, 2020.

social disclosure requirements and their integration into corporate reporting obligations[42]. By mandating large public-interest entities to disclose information regarding environmental topics, social and employee issues, human rights and anti-corruption practices, the Directive acknowledged that issues relating to climate change, environmental degradation, social inequalities and corporate governance practices could not be adequately addressed by requesting information in financial reports alone.

The NFRD marked a shift in concepts. Sustainability reporting would transition from an environment of voluntary CSR speak to one where regulated transparency became the norm. Non-financial information would acquire structured disclosure obligations and, in doing so, would transcend the world of voluntary communications and enter the era of corporate governance. Yet, despite the reclassification, the Directive was designed to create a harmonization of sorts; the requirements for standards, materiality, and even the approach to the validation of its contents would, however, give rise to significant discrepancies from one Member State to another. The need to address the inconsistencies in the information disclosed, however, gave rise to the creation of the Corporate Sustainability Reporting Directive (CSRD), which would introduce a range of more rigorous obligations for sustainability disclosures[43]. The scope of the companies obligated to make disclosures would expand, external validation would become required, and sustainability reporting disclosers would all conform to the same European Sustainability Reporting Standards (ESRS). In doing so, it would enshrine into law what has been a concept under debate: double materiality[44]. As defined in the context of the CSRD, it will encompass the financial materiality of sustainability risks while also encompassing impact materiality; thus, firms must assess the influence of their operations on the societies within whose environments they operate. The enshrinement of the concept of double materiality stands as an important evolution in this regard. The earlier, market-driven conceptualization of ESG disclosures attuned the concerns raised by firms' disclosures to the risks that threatened the financial performance of those firms impacted by sustainability risks. The CSRD accountability framework that has been established will require firms to assess both forward-facing impacts and backward-facing impacts on their financial performance in their disclosures to the public. Yet, although it will impose an obligation upon firms to assess themselves through this lens, it will complicate the waters for firms attempting to adhere to this new requirement as it will seek to impose multidimensional concepts on straightforward reporting structures.

Thus, we see that the move from NFRD to CSRD represents a wider regulatory expansion for the integration of ESG concerns into firm governance. Sustainability disclosures will not be "ad-hoc" and optional but will become a required component of corporate governance. The obligations for sustainability reports will be encapsulated within statutory requirements that will not be subject to varying interpretations from one Member State or even one firm to another; the need for external validators for assessments of these reports to be conducted to ensure their validity will also act as a

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[42] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 on disclosure of non-financial and diversity information (Non-Financial Reporting Directive – NFRD), Official Journal of the European Union.

[43] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 as regards corporate sustainability reporting (Corporate Sustainability Reporting Directive – CSRD), Official Journal of the European Union.

[44] European Commission, Corporate Sustainability Reporting Directive Proposal, 2021; World Economic Forum, Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation, 2020.

de facto regulator of de-priving firms of any opportunity for concealing material impacts from stakeholders. The expansion from a regulatory requirement for corporations that produce securities traded on European markets to market participants that interact with those corporations through the Secure Finance Disclosure Regulation (Regulation (EU) 2019/2088 – SFDR), however, takes this expansion in yet another direction[45]. Rather than focus on corporations that issue securities that must account for sustainability risks, the regulator has turned its attention to market participants; asset managers, institutional investors, pension funds, and financial advisers must all account for how they incorporate sustainability risks into their investment advice or the decision-making processes that accompany their investment advice for them to recommend specific investments to their clients.

The significance of this development is that the SFDR's obligation to standardize sustainability disclosure requirements transforms the role of asset managers. They are to integrate, not merely consider, sustainability risks in their investment processes. The "comply or explain" requirement, for example, makes them account publicly for how those risks affect the products they offer, how they recommend them, and how they act as active owners[46]. The impact on asset managers extends beyond risk management to product design and engagement practices. The SFDR's taxonomy of financial instruments also changes the role of sustainability in the definition of investment products. Asset managers who wish to label their products as having environmental or social benefits (Article 8) or as sustainable investments (Article 9) face enhanced disclosure requirements. Sustainability is no longer an ancillary characteristic of investment products; it is central to their definition[47].

The drive behind this regulation is not only a desire to end greenwashing in the sustainable finance market. Although greenwashing was likely one motivator, the resulting need for harmonized definitions and disclosure requirements also maps out the future of ESG in financial markets. The new requirement for harmonized formats for core sustainability disclosure eliminates the potential for investors to be misled by asset managers who wish to publicize their commitment to sustainability while ignoring the actual product they offer. Yet it also takes the first step in a longer journey: it establishes a common ESG logic for all financial actors in the market. In another sense, then, the SFDR signifies the financialization of ESG. Responsibility is no longer only reported upon; it is now part of the asset manager's fiduciary duty and risk assessment process. The role of sustainability is no longer only one of moral appeal; it is now one of technical necessity in risk management. Sustainability metrics that guide investment decisions and performance evaluations have replaced moral arguments in the investment process. The allocation of capital depends on metrics that asset managers have not previously considered. The influence of the SFDR on EU financial regulation goes beyond its initial objective of requiring asset managers to account for sustainability risks in their investment processes. It is the first step in a wider project to integrate sustainability metrics into financial processes.

Whereas the CSRD requires companies to disclose how they integrate sustainability into their business model, the SFDR requires financial advisers and asset managers to disclose how they integrate sustainability into their investment recommendations. The EU Taxonomy Regulation (EU

[45] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR), Official Journal of the European Union.
[46] Regulation (EU) 2019/2088 (SFDR), arts. 3–6; European Commission, Strategy for Financing the Transition to a Sustainable Economy, 2021.
[47] Regulation (EU) 2019/2088 (SFDR), arts. 8–9.

Taxonomy Regulation 2020/2032) goes a step further. Rather than merely ask for transparency about integration, it imposes a classification system for economic activities that can be considered environmentally sustainable[48].

The Taxonomy Regulation defines its classification system through a two-step approach. First, it defines the environmental objectives that economic activities must contribute to if they are to be considered sustainable. The six objectives that all economic activities must contribute to if they are to be classified as sustainable include climate change mitigation, climate change adaptation, the sustainable use of water resources, the transition towards a circular economy, pollution prevention, and the protection of biodiversity and ecosystems[49]. Second, it outlines the criteria for each objective that an economic activity must comply with to be classified as sustainable. An economic activity must either: (1) make a substantial contribution to achieving at least one of the six environmental objectives; (2) do no significant harm to the other five objectives; (3) comply with the social safeguards outlined in Annex I of the Taxonomy Regulation[50]. The structure of the Taxonomy Regulation's criteria for determining whether an economic activity should be classified as sustainable therefore reflects an effort to balance environmental ambition with economic feasibility. The introduction of such a classification system is a new development in regulatory strategies for corporate social responsibility (CSR). Unlike previous regulations that have based their requirements for accountability on voluntary commitments, the Taxonomy Regulation establishes a framework for corporate accountability that is based on clear boundaries and limits interpretative flexibility. Its aim is to avoid greenwashing by linking sustainability classifications to technical definitions and limits.

Yet, the Taxonomy appropriates sustainability into the mechanisms of capital allocation. Financial products that comply with the SFDR must indicate what proportion of their capital is invested in activities conforming to Taxonomy definitions[51]. Thus, regulatory classification has implications for reporting requirements, portfolio composition, and, to some extent, the flows of capital. These elements are thus associated with one another. This development shows that ESG practices are institutionalizing. No longer is it simply a matter of reporting frameworks or investors' choices, but it becomes a legally codified domain with limits, thresholds, and audits. Yet, at the same time, it raises questions of a normative kind. Who is best placed to determine what is the sustainable economic activity; which technological routes should be followed; at what level should environmental burdens be set in transitional periods? The definitions laid down by the Taxonomy seem to adopt a particular set of solutions, but the framework that has been set up indicates the potentialities and vulnerabilities of entrapping sustainability in structures of financial governance.

Thus, the CSRD, SFDR, and EU Taxonomy form an integrated regulatory framework[52]. The classes of information that need to be disclosed; classification systems for financial products; and definitions of economic activities fit together. They imply a loop between corporate disclosing practices; the behavior of investors; and the development of regulatory requirements. In this institutionalization,

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[48] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment (EU Taxonomy Regulation), Official Journal of the European Union.
[49] Regulation (EU) 2020/852 (EU Taxonomy Regulation), art. 9.
[50] Regulation (EU) 2020/852 (EU Taxonomy Regulation), arts. 3 and 18.
[51] Regulation (EU) 2019/2088 (SFDR), art. 5; Regulation (EU) 2020/852 (EU Taxonomy Regulation), art. 8.
[52] Directive (EU) 2022/2464 (CSRD); Regulation (EU) 2019/2088 (SFDR); Regulation (EU) 2020/852 (EU Taxonomy Regulation).

investors must pay attention to non-financial practices as much as they do to cash flows. The next chapter will explore these implications, focusing on concepts such as sustainability-related financial risks; sustainability risks; financial projections and projections of financial sustainability.

3.3 ESG, Risk Pricing and the Financialization of Responsibility

The institutionalization of ESG within market and regulatory infrastructures ultimately serves a common financial function: the integration of sustainability concerns into risk evaluation and asset pricing. When environmental, social, and governance (ESG) variables are translated through the financial materiality lens, they become measurable characteristics that affect expected return, volatility, downside risk, and discount rates[53]. Thus, rather than being a prescriptive framework, ESG is a mechanism for rendering invisible risks visible in terms of market signals.

Traditional asset pricing models only consider factors such as macroeconomic factors, sectoral influences, leverage, and positive cash flows. However, ESG factors consider these elements in a new context: corporate sustainability and long-term viability. Climate change risks, carbon pricing regimes, technological developments in energy production/distribution, supply chain weaknesses, litigation costs, and governance deficiencies, and reputation damage all signal that ESG materiality is reconfiguring traditional notions of financial risk[54]. Companies operating in carbon-intensive sectors with weak governance structures or vulnerable to social controversies will be viewed as carrying higher structural risks. Integrating ESG factors will, therefore, reconfigure expected returns, weights, and engagement strategies for integrating these factors. Moreover, ESG risk factors differ from classical financial risks in critical respects. They are long-term, nonlinear, and systemic risks. Climate risks materialize in regulatory changes, stranded asset values, and extreme weather events whose financial consequences unfold over decades. Governance weaknesses can trigger sudden reputational shocks with immediate market impact. Social unrest in supply chains can disrupt operations without warning, exceeding the limits of conventional financial metrics for measuring vulnerability. Integrating ESG factors in financial risk analysis, therefore, reflects a shift in emphasis toward considering a broader spectrum of time horizons.

From a corporate strategy perspective, however, this development alters managerial incentives in subtle but non-trivial respects. If markets have indeed begun to view ESG performance as a valid indicator of long-term resilience and risk management capability, sustainability investments may affect the firm's financing conditions and perceived stability in ways that impose constraints. A reduced perceived risk of loss may, for instance, lower the firm's cost of debt, enhance its equity valuation, and broaden its access to institutional investors[55]. The converse effect may obtain should

[53] E. Pollman, "The Making and Meaning of ESG", University of Pennsylvania Law Review, 2022; G. Giese et al., "Foundations of ESG Investing", The Journal of Portfolio Management, 2019.
[54] G. R. Krippner, "The Financialization of the American Economy", Socio-Economic Review, 2005; G. A. Epstein (ed.), Financialization and the World Economy, Edward Elgar Publishing, 2005.
[55] S. El Ghoul, O. Guedhami, C. C. Y. Kwok, D. R. Mishra, "Does Corporate Social Responsibility Affect the Cost of Capital?", Journal of Banking & Finance, 2011.

the firm be repeatedly embroiled in ESG controversies; in this case, the perceived upside potential may be insufficient, yielding risk premia or exclusion from sustainability-focused investment vehicles. Responsibility thus becomes a matter of market-based accountability. An important caveat is that this transformation does not require any assumption of universal acceptance of the empirical literature's claims about the financial effects of ESG performance. The literature is, after all, diverse and contains studies reporting positive correlations, neutral findings, and context-dependent results. The structural significance of its institutionalization as a market pricing variable, however, is that sustainability indicators acquire a performative quality regardless of whether their measurement is socially warranted. They inform market models, affect analyst expectations, and influence the parameters of portfolio construction algorithms.

This performative quality reveals a more general phenomenon: the financialization of sustainability[56]. In the earlier phase of the CSR discourse, responsibility was a managerial concern that was grounded in dialogue with stakeholders and exercised through managerial discretion and reputational signaling. In the currently financialized ESG discourse, it is a capital market concern that disciplines firms through pricing mechanisms, index inclusion, and investor engagement[57]. The corporation is incentivized to take account of sustainability concerns not only because they are normatively desirable but also because they may affect its access to investors and the resources it can command.

Yet another caveat is that the conceptual framing of ESG concerns as risk factors also imposes limits on the way sustainability issues are addressed. If the factors that are relevant to the firm's sustainability performance are filtered through the lens of their contribution to the value of the firm's assets, certain issues may acquire a relevance that they would not possess in a more inclusive conceptualization. The focus on financially relevant risk factors, in certain contexts at least, may narrow the scope of corporate responsibility to those issues that are visible to the firm's financial situation. The transformation of responsibility into a pricing factor thus reinforces the strategic significance of ESG concerns while reconfiguring its normative contours[58]. One of the most prominent questions in the field of sustainable finance involves whether better ESG performance is associated with a lower cost of capital[59]. This question is of central interest in both the academic literature and the practice of investment management because it links factors that are typically viewed as socially desirable to factors that affect the financial situation of firms and their access to investors. If better ESG performance reduces investors' perception of risk or increases their expectation of the stability of future cash flows, investors may be willing to accept lower expected returns, which in turn will reduce the cost of capital that the firm must pay. If, however, ESG factors are viewed as creating costs or inefficiencies that do not contribute to positive financial outcomes, investors may regard them as an agency problem that reduces shareholder value.

Empirical studies report a wide range of findings. Some studies determine that higher ESG-rated firms exhibit lower idiosyncratic risk, lower downside risk volatility, and increased access to long-

[56] G. A. Epstein (ed.), Financialization and the World Economy, Edward Elgar Publishing, 2005; G. R. Krippner, "The Financialization of the American Economy", Socio-Economic Review, 2005.
[57] R. Shamir, "The Age of Responsibilization: On Market-Embedded Morality", Economy and Society, 2008.
[58] E. Pollman, "The Making and Meaning of ESG", University of Pennsylvania Law Review, 2022.
[59] C. Revelli, J. L. Viviani, "Financial Performance of Socially Responsible Investing (SRI): A Meta-Analysis", Business Ethics: A European Review, 2015; P. Krüger, "Corporate Goodness and Shareholder Wealth", Journal of Financial Economics, 2015.

term sources of capital. However, other research reports no effect or effects conditional on sector, region, or even methodological aspects related to the computation of ESG ratings[60]. The range of empirical findings reflects both the difficulty of identifying established channels of influence and the evolution of data relating to sustainability. Yet the analytical structure that underlies the diversity of empirical findings exceeds the implications of such variance. The question of whether the cost of capital is related to ESG ratings entails a significant revision in the conceptualization of ESG itself. In an earlier context, the question was what corporations had a duty to pursue in light of their impact on the social world. In its present-day, financially framed context, the question is whether it is possible to assume that the performance of corporations in relation to sustainability influences the required return on shares that investors demand. Responsibility is thus defined only by its financial relevance.

In its own right, the question of the cost of capital addresses a wide range of theoretical questions regarding the nature of the corporation. The perspective that asserts the relevance of ESG ratings assumes that this factor enhances value when it mitigates firms' long-term risks, builds stronger relationships between firms and stakeholders, and improves operational efficiency. An investment in sustainability that addresses existing inefficiencies would, therefore, appear consistent with the interests of shareholders who benefit from improved cash-flow sustainability and resilience in adverse conditions. From an alternative perspective, however, all expenditures that relate to an ESG rating or contribute to enhancing ratings may be viewed as "shareholder expense." Such expenditure can be justified on social grounds, but in no sense does it respond to an incentive associated with securing returns on investment.

Such perspectives evoke an earlier debate regarding the primacy of shareholders versus stakeholders in firms. In its current iteration, however, it takes on a financialized structure.

Even where ESG-related financialization may have only mild effects in terms of altering firms' costs of capital in relation to their risk exposures, market dynamics are likely to intensify any effects that may be observed. The demand for investment products with sustainability criteria builds institutional structures that exert influence over markets, drive the formation of benchmark-linked investment funds, and regulatory schemes for classifying assets into sustainability-defined categories. In a market in which a substantial pool of capital becomes available for investment in ESG-compliant securities, a theoretically small reduction in costs associated with raising funds can lead to a substantial increase in the demand for eligible assets. In this sense, financing conditions have an impact that extends beyond that achieved by factors that determine expected returns. Thus, the cost of capital debate illustrates two of the distinct effects of financialization associated with ESG: that it increases transparency regarding firms' integration of long-term risks and sustainability-related concerns into their expected return on capital investments and that it alters patterns of capital allocation by considering factors unrelated to traditional indicators of financial performance.

No matter how the cost of capital for ESG-rated firms may vary in practice, therefore, the primary question posed by the debate is not one of empirical observation, but rather one involving the structure that exists beneath such debates in terms of definitions and assumptions regarding responsibility, the

[60] D. Y. Tang, Y. Zhang, "Do Shareholders Benefit from Green Bonds?", Journal of Corporate Finance, 2020; C. S. Fernando, M. P. Sharfman, V. B. Uysal, "Corporate Environmental Policy and Shareholder Value", Journal of Financial and Quantitative Analysis, 2017.

nature of firms and their governance, and the mechanisms through which investors acquire information.

The reconfiguration of the problem set has important implications for strategy. If corporate managers regard ESG performance as a factor influencing investor demand and financing conditions, then sustainability concerns enter into the management of the capital structure, investor relations and long-term strategy. Yet the emphasis on cost-of-capital effects may encourage a focus on those ESG dimensions that are most observable to investors and rating agencies, which may reinforce a metric mentality. The financialization of responsibility thus increases its strategic relevance even as it makes it subject to the criteria of financial evaluation.

The discussion of ESG and cost of capital illustrates a more general transformation: corporate responsibility is no longer discussed in terms of ethical expectations or legitimate reputation, but as a factor that enters into theories of asset pricing and resource allocation. The next section brings these developments together under the heading of financialization, considering how the incorporation of sustainability into market discipline reconfigures the architecture of corporate accountability.

The developments discussed in earlier sections converge into a more general structural transformation that can be characterized as the financialization of corporate responsibility. This does not mean that ethical expectations still do not govern corporate conduct. However, it does mean that the primary mechanisms through which responsibility is assessed, rewarded and punished have shifted from non-financial to financial markets and resource pricing mechanisms. In early conceptualizations of CSR, corporate responsibility was framed as a response to questions of legitimacy and obligation toward non-economic actors. It depended on managerial discretion, dialogue with stakeholders and reputation for accountability. The strategic framing of CSR subsequently reframed the concept in instrumental terms, viewing social responsibility as contributing to competitive advantage and long-term value creation. With ESG, however, concerns that were previously justified in non-financial or value-based terms are being reconfigured in terms of financial materiality, risk assessment and resource allocation.

Financialization operates through several interrelated channels. First, sustainability indicators are quantified and incorporated into asset pricing models and portfolio construction algorithms. Second, institutional investors and asset managers exercise governance over firms by making capital access conditional on ESG performance. Third, regulatory frameworks codify disclosure obligations and classification systems that align sustainability evaluation with financial reporting structures[61]. Together, these channels embed responsibility within the architecture of market discipline. This embedding reconfigures corporate incentives. When ESG performance affects investor demand, index inclusion, and financing conditions, corporate managers face market-based incentives to take sustainability into account. Responsibility becomes economically consequential, not only as a matter of societal expectation but also as a matter of risk that can affect access to capital and firm valuation. In this sense, financialization enhances the strategic salience of sustainability by linking it to firm performance.

At the same time, the financialization of responsibility raises normative and conceptual questions. The emphasis on financially material risks may undermine social and environmental concerns that

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[61] S. L. Gillan, A. Koch, L. T. Starks, “Firms and Social Responsibility”, Journal of Corporate Finance, 2021

lack market-invisible manifestations[62]. The complexities of sustainability challenges are reduced to metrics that are comparable, tradeable, and priceable. The source of authoritative evaluation shifts to investors, rating agencies, and regulators while corporate responsibility is reconfigured along financial logics that emphasize measurability, standardization, and market compatibility. This dual movement of amplification and constraint thus characterizes the paradox of ESG's institutionalization. On the one hand, sustainability concerns become embedded in the operational logic of global markets. On the other hand, their institutionalized expression is shaped by the logic of financial evaluation. The question is no longer what corporations owe to society, but how responsibility affects their risk profiles and capital flows. The financialization of corporate responsibility thus stands neither in place of CSR, nor as its culmination. It represents a reconfiguration of the mechanisms through which responsibility is exercised. By examining this reconfiguration, it may be possible to determine whether ESG provides an appropriate conceptualization of long-term sustainable value creation, or whether other strategic concepts are needed. The next chapter will consider corporate strategy and how firms respond to the financialized incentives for ESG performance and how it affects organizational levels of strategic decision-making.

The analysis developed in this chapter demonstrates that ESG is no longer conceptual or voluntary. It is operationalized through the proliferation of ratings, benchmarks, investor integration, and increasingly dense regulatory frameworks that impact how sustainability indicators are used to make decisions about capital allocation. Institutionalization occurs through disclosure obligations, product classification schemes, and standardized metrics that incorporate sustainability performance. Institutionalization ultimately results in the financialization of responsibility. Environmental, social and governance factors are incorporated into models that estimate risk, cost of capital, and optimize portfolio value. Responsibility is translated into metrics that are evaluated through pricing mechanisms and enforced through market logics. The shift from normative to financial materiality does not eradicate ethical concerns; it relocates them within a logic of financial evaluation.

In my view, the developments that have led to the financialization of corporate responsibility are neither entirely positive, nor negative. Financialization increases the strategic salience of sustainability as it is linked to economic consequences. Companies cannot ignore how responsible they are as this impacts their access to financing and their long-term viability. The risk materiality approach, however, may limit corporate accountability to factors deemed relevant by investors, potentially sidelining issues whose societal importance is undeniable, even if their impact on the company's financial performance is not.

The central interpretative question posed by this chapter is therefore: How can we promote positive outcomes from this materialization of responsibility? The next chapter will consider the role of corporate strategy in addressing this question by positioning the integration of ESG factors into financial decisions at a stage in the decision-making process where compliance and metric optimization are less relevant.

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[62] C. Mayer, "Valuing the Invaluable: How Much is the Planet Worth?", Oxford Review of Economic Policy, 2019.

4. CHAPTER III - ESG and Corporate Strategy: Integration, Incentives and Strategic Limits

4.1 ESG as Strategic Integration vs Compliance Tool

The financialization of ESG was covered in the previous chapter. This chapter looks at the implications for the strategic action of the firm. All that was covered previously on the financialization of ESG should be kept in mind. If ESG is to be an embedded factor in risk pricing, capital allocation, regulation and investor metrics, then ESG should be an important consideration for all managers when making strategic decisions. But how firms choose to respond to the new set of incentives that ESG introduces is likely to differ significantly. The effects of ESG can be deep or superficial, revolutionary or evolutionary. They may represent a fundamental change to the competitive strategy of the firm or they may involve the addition of a set of compliance and risk-reduction functions that do not disrupt the firm's underlying competitive strategy[63].

ESG integration is at its most transformative at a strategic level, where the considerations are factored into the company's thinking around its strategy. Therefore, a company that is taking a transformative approach to ESG integration would, for example, consider whether to include sustainability issues in its capital budgeting, its supply chain management practices, its product development activities, and its multi-year investment plans. So the company's carbon reduction plans, its efforts to enhance governance practices and mitigate the risks from increasing activism from stakeholders, and its social impact commitments are not items that are disclosed to stakeholders, but are instead simply part of the company's business operations. In other words, a company that is pursuing a transformative approach to ESG integration is considering ESG issues when taking more decisions across the business. The aim is to support the company's transition to a low carbon economy, protect its governance framework from the growing influence of activist shareholders, meet the evolving expectations of customers and other stakeholders and, in the process, ensure that sustainability is fully integrated into the firm's DNA, thereby contributing to its long-term competitive advantage[64].

From a business strategy perspective, integrating ESG into the development of dynamic capabilities is one option[65]. Companies that can read the future and foresee the changes coming (a more regulated world, a technological revolution, and a public that is increasingly aware of sustainability issues) will be able to benefit from the advantage of sustainability. By investing in green technology, circular economy models, and good governance practices, the goal is to minimize the risk of being negatively affected by future regulations, technological innovations, and changes in social attitudes, which on the one hand protects capital in the long term and on the other hand opens up new growth

[63] G. A. Epstein (ed.), Financialization and the World Economy, Edward Elgar Publishing, 2005; G. R. Krippner, "The Financialization of the American Economy", Socio-Economic Review, 2005.
[64] M. E. Porter, M. R. Kramer, "Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility", Harvard Business Review, 2006; M. E. Porter, M. R. Kramer, "Creating Shared Value", Harvard Business Review, 2011.
[65] D. J. Teece, G. Pisano, A. Shuen, "Dynamic Capabilities and Strategic Management", Strategic Management Journal, 1997.

opportunities in emerging markets and new business niches. Therefore, ESG is no longer just a matter of prevention, but also a strategic issue[66].

The financialization of ESG has created its own counteractive effects. Today, ratings, benchmarks and reporting frameworks have created a market where companies' ESG performance can be "traded" and measured[67]. Managers are under pressure to achieve the predefined performance levels required to obtain a certain investment grade from investors. Rather than focusing on the actual sustainability work, managers are more concerned with highlighting their performance in relation to the metrics included in the ESG rating, benchmark or reporting framework. Their primary goal is to achieve the highest possible grade on the most influential ESG indicators for their stakeholders. Real changes to the company's core operations are often avoided or maintained at a minimum. Instead, the goal is to manipulate the key performance indicators to achieve the best possible ESG rating[68].

It can be argued that the compliance-driven approach is a rational response to the new market demands. As capital markets become a source of finance for companies that comply with ESG standards or are included in specific sustainability indices, achieving a high ESG rating becomes a key business objective. Companies will then focus on those ESG issues that are measured and reported by investors in an attempt to mitigate any risk, avoid being excluded from the capital markets, and to avoid any negative regulatory or market attention. Ultimately, the practice of ESG integration is about risk management and ensuring business continuity, rather than about transforming business models or leading any technological changes[69].

While some companies may be able to align their compliance-based sustainability strategy with their business interests, there is no reason why a company cannot also implement an integrative strategy for addressing the complex bundles of sustainability issues and a compliance-based strategy in the context of the financialized ESG regime. A company that responds to capital market incentives to internalise ESG issues into its management practices and to accept the sustainability performance that can be measured, may well focus on those ESG issues that are easiest to quantify and measure. This will concentrate management's attention away from less transparent, longer term or more context-dependent sustainability issues that are not yet aligned with rating agency metrics or regulatory requirements[70].

One of the clearest manifestations of this conflict in the world of corporate sustainability, particularly when it comes to climate transition plans. Companies have taken on so-called "corporate net-zero" targets that are now being demanded by shareholders and investors. What levels of real change are needed for companies to achieve these goals, and what are they actually planning to do in practice to get there? The answer varies by company, but it is not always the same as what might be considered responsible practice[71]. Some companies are including the required emissions reductions in their

[66] D. J. Teece, "Explicating Dynamic Capabilities: The Nature and Microfoundations of (Sustainable) Enterprise Performance", Strategic Management Journal, 2007; S. L. Hart, "A Natural-Resource-Based View of the Firm", Academy of Management Review, 1995.
[67] F. Berg, J. Koelbel, R. Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings", Review of Finance, 2022
[68] D. M. Christensen, G. Serafeim, A. Sikochi, "Why Is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings", The Accounting Review, 2022.
[69] S. L. Gillan, A. Koch, L. T. Starks, "Firms and Social Responsibility", Journal of Corporate Finance, 2021.
[70] R. Shamir, "The Age of Responsibilization: On Market-Embedded Morality", Economy and Society, 2008.
[71] A. Edmans, "The End of ESG", Financial Management, 2022.

capital expenditure plans, and are investing in low-carbon technologies and other solutions. But for other companies the transition to meeting their corporate net-zero commitments seems less dramatic, involving greater use of emissions offsets and other arrangements – and an expectation that the needed transition will occur further in the future, giving time for any necessary short-term disruptions to operations to work through. The difference in these cases is one of intention and tactics rather than substance.

Financialization of ESG has produced a strategic dilemma: It is now possible to have a greater influence on the economy through the sustainability filter in a much more material way, not least by linking it to the cost of capital, to investor pressure, and to regulation. On the other hand, the behavior that is financially induced by ESG, the metrics that need to be managed in order to show that a company is engaged and the reputational aspects of ESG that need to be dealt with, can be seen more as a way of adjusting to the expectations of the financial markets than as a means of bringing about change[72]. The task of being a CEO has been enormously complicated by a series of new challenges that arise from the fact that the topic of ESG will for many years to come be seen in two very different ways. The question then arises as to which form of ESG is seen as a strategic factor for shaping the company's activities over the coming decades; and which is just a matter of defending the status quo and adjusting the company's metrics and reputation in order to cope with the new criteria of financial markets[73]. The difference between the two is very fine and extremely important. On the one hand, ESG can be seen as the factor that enables companies to position themselves in such a way that they will be better able to cope with the future challenges that arise in the economy, in the markets, and in the environment. On the other hand, the factor that enables companies simply to cope with the expectations of investors, and to change just a few figures and images in order to maintain their current position.

The impact of ESG on strategy will be dependent on the way in which the financial incentives of ESG are being implemented by companies. If companies take the best lessons from the purposes of the companies they invest in to the heart of their decision-making over the future of their business then ESG should have a long term impact on the business in a number of positive ways including increasing the overall resilience of the business and facilitating a more dynamic and agile competitive response to others. On the other hand if ESG is merely treated as a compliance and disclosure matter akin to reporting risk or adhering to governance codes then it will very rapidly descend into a formalistic, ritualistic and entirely unmeaningful practice, a charade and little more[74]. The next chapter of this blog will look at the characteristics that need to be present for companies to benefit from the sustainability component of ESG on a sustainable basis rather than merely meeting the financial market's current requirements in relation to disclosure.

ESG Reporting is not the same as ESG Governance. The extent to which the board, pay and KPIs take into account ESG issues is material to whether any stakeholder commitments made will have any substance or are simply a PR exercise[75]. Practices which support the embedding of ESG issues into practices, processes and culture include: • including ESG metrics in long term incentive plans

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[72] G. A. Epstein (ed.), Financialization and the World Economy, 2005; G. R. Krippner, "The Financialization of the American Economy", 2005.
[73] E. Pollman, "The Making and Meaning of ESG", University of Pennsylvania Law Review, 2022.
[74] S. L. Gillan, A. Koch, L. T. Starks, "Firms and Social Responsibility", Journal of Corporate Finance, 2021.
[75] L. A. Bebchuk, R. Tallarita, "The Illusory Promise of Stakeholder Governance", Cornell Law Review, 2020.

(LTIPs) • including ESG considerations in the board process when considering capital expenditure approvals • including ESG considerations in risk management processes Conversely practices such as relegating all ESG issues to the reporting team and requiring no input from other parts of the business are unlikely to result in any material changes to the companies way of working and therefore are unlikely to have any substance.

In our working paper we examined the relationship between ESG and capital markets as another example of short-termism. While ESG is often seen as a way to bring a long-term perspective to the economy through sustainability, capital markets are characterized by short-termism and focus on short-term developments such as quarterly earnings, short-term risks, etc[76]. Companies are often pushed to do certain things in the ESG sector as these can bring about quick benefits such as higher ratings and increased transparency. However, the truly sustainable value creation that these measures are intended to bring about is often realised many years after the measures have been taken. This is known as the "financialisation of sustainability": the adaptation of the highly uncertain, long-term environmental goals to the short-term focus of the capital market.

ESG reporting is being mandated and requested by a growing number of stakeholders. At the same time, investor engagement is becoming an increasingly significant force for change in the transition to a low-carbon future. Boardrooms are being bombarded with questions from institutional investors on climate transition plans, governance and disclosure. Successful engagement can act as a major catalyst for change. Particularly when underpinned by the threat of a vote or divestment commitment. While differing in many respects from traditional activism, ESG engagement also has the potential to achieve real change from within rather than imposing change on companies. The engagement process needs to be credible in order for companies to be incentivised to change their behaviour, and in order for ESG considerations to be positively correlated with long term value creation.

4.2 ESG, Value Creation and Competitive Positioning

It’s time to move beyond the simplistic talk of ESG as compliance and risk. The financialisation of sustainability has brought into play a whole range of new pressures on organisations, from the activism of shareholders to regulatory enforcement and markets pricing in sustainability. But how are organisations using ESG, as a purely defensive measure to mitigate these new pressures and fines, or as a more dynamic way to open up new sources of competitive advantage? The answer to that question is not straightforward and it is one that boardrooms need to grapple with today[77].

For most people, ESG is about risk management. Companies identify potential future regulations, ESG issues and corporate governance risks, and then take steps to mitigate them through the adoption of sustainable practices. The goal of ESG risk management is to ensure business continuity and to mitigate the occurrence of adverse events that could damage the business and the company’s image[78].

[76] G. A. Epstein, 2005; R. Shamir, “The Age of Responsibilization”, 2008.
[77] G. A. Epstein, Financialization and the World Economy, 2005; E. Pollman, “The Making and Meaning of ESG”, 2022.
[78] S. El Ghoul et al., “Does Corporate Social Responsibility Affect the Cost of Capital?”, Journal of Banking & Finance, 2011.

The main benefits of ESG risk management include: - Capital preservation - Lower perceived volatility - Higher investor confidence However, ESG risk management is a purely defensive strategy and does not offer any offensive benefits. To achieve offensive benefits, it is necessary to move to the next level of ESG and to integrate ESG into the business strategy. If companies only adapt to future regulatory requirements, they will maintain their image and reputation, but if they revolutionise their value chain in line with new sustainability principles, they will also fundamentally change the rules of competition in their industry[79]. The key question is whether ESG is used for marginal or incremental adjustments to current business practices, or for more transformative changes[80]. For example, a procurement policy to manage the risks of the supply chain can reduce the risk of social and environmental controversies related to purchases. However, a company can revolutionise its supply chain by introducing a closed-loop economy and renewable energy, and this can have an impact on costs, business models and innovation activities. Instead of setting up a compliance committee to monitor good corporate governance practices, a company can revolutionise its long-term business strategy by integrating ESG factors into investment decisions and managers' bonuses. In these cases, companies do not see ESG as a constraint in the market, but as an opportunity to rethink their business in a more innovative way. Indeed, companies operate in a financialized ESG regime where the performance of sustainability activities is evaluated in terms of measurable targets that can be linked to monetary incentives or sanctions. This does not necessarily mean that sustainability activities are sources of competitive advantage for the firm. In the absence of such an advantage, ESG amounts to no more than a regulatory compliance layer that does not differentiates between firms and therefore does not change their relative positions. In order to avoid this uninteresting and homogeneous form of compliance, it is necessary that sustainability be integrated into the more material aspects of companies' products, technologies and planning horizons. In this way, ESG ends up being a factor of strategic differentiation between firms.

One possible route through which ESG influences firm competitiveness is through the creation and maintenance of intangible assets. Intangible assets are a significant and growing portion of firm value and encompass items such as brand capital, organisational culture, employee human capital and trust and relationships with stakeholders. These types of assets are inherently difficult to replicate, are deeply path dependent and are rooted in complex bundles of organisational practices. Consequently, substantive engagement with ESG issues should, a priori, potentially impact the firm's intangible assets[81].

Reputation is one of the more tangible links between ESG and competitive advantage. A good reputation for CSR and sustainability can generate customer goodwill, boost investor confidence, win the favour of officials and other stakeholders, and strengthen relationships with customers and suppliers. A good reputation acts as a symbol of success, as well as a shock-absorber to cushion the company from reputational risks and from external market swings. Companies that claim to practice what they preach in terms of sustainability can build up reputational capital to maintain their

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[79] M. E. Porter, M. R. Kramer, "Strategy and Society", 2006; S. L. Hart, "A Natural-Resource-Based View of the Firm", 1995.
[80] D. J. Teece, "Explicating Dynamic Capabilities", 2007.
[81] J. Barney, "Firm Resources and Sustained Competitive Advantage", Journal of Management, 1991.

competitive edge, as well as to capitalise on any opportunities that may arise in a crisis situation[82]. Embedding ESG factors into a company's operations can also yield numerous sustainability benefits and thereby also impact on the company's internal affairs. A company that views itself as a sustainable business is likely to see an increase in the motivation of its employees. This is because a company with a genuine sustainability approach will be more likely to attract the right type of skills and foster a long-term perspective among employees. Human capital is increasingly regarded as a key strategic resource in the knowledge economy[83]. While many potential impacts on human capital from ESG issues are difficult to quantify and are therefore often intangible, employee attitudes may be influenced by a company's reputation for social responsibility and sustainability. Companies with such a reputation may find it easier to retain key employees, boost their motivation and productivity.

Stakeholder relations is an important factor. Companies which proactively deal with the environmental and social impacts of their activities and products will generally have better relations with their suppliers, local communities and authorities. The relational capital of a company in this context can lower transaction costs, reduce the risk of conflict and therefore enhance business sustainability[84]. With the growing global focus on supply chains, combined with an increasingly complex and politically unstable world, effective stakeholder engagement on sustainability issues can be critical to business continuity.

The value of intangible assets is cumulative and interactive. Reputation has a positive effect on the attraction of talent, while sound governance practices are the foundation for the confidence of shareholders. Achieving sustainable development is a way for companies to earn respect from stakeholders. When ESG is fully integrated into the strategic decision-making process, beyond just being included in the reporting, it can produce positive synergies. Companies can then build lasting success[85]. Creating intangible assets requires a basis of credibility. This means that if companies promise sustainable development achievements that are not lasting or genuine, then any short-term reputational gain will be short-lived. Moreover, while the financial markets reward companies that behave responsibly in terms of ESG, they can at the same time also expose them to a heightened risk of the stigma of "greenwashing". Ultimately, for ESG to be successful in terms of intangible assets, companies need to ensure that their communications match up with their corporate governance practices and operational behaviour.

Risk management and intangible values are only some of the aspects of ESG. Companies are starting to use ESG as an innovation and transformation vector. Indeed, in numerous fields, from carbon pricing to the digital era and the changing consumer behaviour, ESG criteria are increasingly taking centre stage. As such, sustainability has become a major factor in designing products and services, conducting R&D and making investments. By using ESG as a strategic compass, companies can better navigate the change and position themselves for success[86].

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82 J. Surroca, J. A. Tribó, S. Waddock, "Corporate Responsibility and Financial Performance: The Role of Intangible Resources", Strategic Management Journal, 2010.
83 J. Barney, 1991; D. J. Teece et al., 1997.
84 R. E. Freeman, Strategic Management: A Stakeholder Approach, 1984.
85 M. E. Porter, M. R. Kramer, "Creating Shared Value", 2011.
86 S. L. Hart, "A Natural-Resource-Based View of the Firm", Academy of Management Review, 1995; D. J. Teece, 2007.

The transition to a low carbon and resource efficient economy is accelerating worldwide. As a result, companies operating in the energy, transport, manufacturing and construction sectors will be under pressure to decarbonise their activities and to prepare for the prospect of increasingly stringent measures to combat climate change. Renewable energy, electrification, the circular economy and the development and use of new materials all require substantial upfront investments. At the same time, companies that set the trends in relation to sustainable business models, new technologies and products are likely to gain access to attractive new business opportunities, achieve compliance with future regulatory requirements and safeguard their competitiveness. ESG-driven innovation may therefore result in first-mover advantages that are difficult for others to make up[87].

While first-mover advantage is often attributed to technology, the institutional aspects of sustainability are just as important. The key here is that companies that engage with regulators, standard setting organisations and industry coalitions early on have a better chance of influencing the sustainability standards and the compliance regimes that follow. Companies can benefit from first-mover advantage by influencing the rules of the game and thereby reducing the degree of uncertainty and by championing sustainable practices and thereby benefiting from the halo effects of sustainability[88]. The institutional and market dynamics of ESG is an increasingly important area of competition. Where companies have the opportunity to influence market developments and where consumer behaviour can be influenced by ESG considerations they will have opportunities to create first-mover advantages for themselves. In consumer markets there are many instances in which the ESG attributes of products will be highly material to consumers and will reinforce the purchasing behaviour of consumers. Where there are opportunities to build a consumer franchise by championing ethical sourcing, by having supply chains that are more transparent and therefore more sustainable, by being more sustainable in production processes, companies have the opportunity to charge a premium to consumers over time as the premium is increasingly justified by the sustainable differentiation.

There is an asymmetric innovation potential of ESG across industries. In low-margin, commoditised industries where consumers have limited scope for choice and are under intense price pressure, it may be challenging to generate a competitive advantage from sustainability-driven innovation. The capital intensity of the business, the stability of the regulatory framework, the technological feasibility of the innovations and the degree of consumer awareness are all factors that can influence the ability of companies to generate a strategic benefit from their ESG activities. The relationship between sustainability and innovation is therefore not automatic, but contingent[89]. Moreover, the financialisation of ESG adds an extra layer of complexity. Companies with a credible transition plan and a convincing innovation story may be able to enjoy the favour of investors, improve their credit rating, benefit from the issuance of sustainability-linked bonds and achieve long-term engagement from institutional investors[90]. At the same time, however, markets tend to set expectations for the improvement of ESG performance in the short term. This can create a conflict between the need to meet short-term targets and the potential for innovation. Companies are invited to assume risk that is

[87] M. E. Porter, C. van der Linde, “Toward a New Conception of the Environment-Competitiveness Relationship”, Journal of Economic Perspectives, 1995.
[88] M. E. Porter, Competitive Advantage, 1985.
[89] J. Barney, 1991; S. L. Hart, 1995.
[90] D. Y. Tang, Y. Zhang, “Do Shareholders Benefit from Green Bonds?”, Journal of Corporate Finance, 2020.

often uncertain, difficult to hedge and the returns of which are far-off and therefore uncertain. This willingness to accept such risks is not always compatible with the need to measure ESG performance on a quarterly or annual basis[91]. The scope for experimentation, the acceptance of the uncertainty of the innovations and the time needed to see the returns of the investment are not always compatible with the control procedures of the markets, which are heavily based on metrics.

ESG innovation is in a peculiar strategic position. It can on the one hand be an opportunity for companies to reinvent themselves and launch new activities, but on the other hand ESG criteria are designed to be measurable and comparable. The challenge for companies is to transform the need to act for sustainability into a lasting competitive advantage. Thus, companies need to link their long-term innovation strategy to their short-term profitability objectives[92]. In the most favorable scenario, ESG is a springboard for companies to carry out their renewal strategy. In the most unfavorable, innovation then becomes no more than a way to meet the obligations of ratings and disclosure.

ESG integration can be a risk-reducing, value-creating and innovation-driven source of competitive advantage, but we consider a sustainable competitive advantage unlikely to be derived from ESG integration. Whether the company's sustainability strategy delivers on its promises will depend on whether the ESG investments are aligned with the company's core competencies, industry structure, policy makers' future agendas and time horizon. Otherwise, ESG risks will become economically irrelevant or misallocated.

We believe that ESG factors will have a material impact on different degrees on different companies in different industries. In capital intensive businesses with unique, high value added products where consumers care about the brand image, companies may benefit significantly from having sustainability features in their products and be able to command a price premium. In more commoditised businesses, where pricing is a main competition parameter and consumers do not incur significant switching costs, material direct benefits to shareholders from ESG are unlikely to be derived. In such cases, sustainability will essentially amount to meeting a minimum set of expectations to be granted a license to operate. We also believe that the impact of regulations will differ between industries. In environmental terms, companies operating in countries where environmental regulation is high and strictly enforced may experience short term gains due to their advanced position relative to competitors. Overall, ESG may also provide greater transparency around future capex requirements and therefore also provide clarity and reduce uncertainty in investment decisions, in part mitigating the effects of more uncertain regulatory frameworks. In more dispersed regulatory frameworks it may be less certain what benefits companies derive from investing in sustainability in advance of regulatory pressures arising, given potential variation in the effectiveness of regulation between countries.

Time is a material factor in respect of a large number of ESG factors relevant to sustainable investment. Long-term processes such as technological change and value chain transformation can take years to bear fruit, and companies with long-term capital structures and patient shareholders are often in a better position to support these types of investments. Companies with short-term performance pressures are generally less likely to engage in costly activities that may not yield

[91] G. A. Epstein, 2005; R. Shamir, 2008.
[92] A. Edmans, "The End of ESG", Financial Management, 2022.

measurable and tangible short-term benefits. The effect of time on markets and the relationship between time and sustainability strategies are also factors that will impact the competitiveness of companies[93].

Companies' ability to implement the outcomes of the ESG organisational capability also plays a significant role. As companies with higher absorptive capacity, more adaptive leadership and cross-functional integration are likely to translate their ESG commitments into a concrete and tangible change within the company, they are able to capitalise on their competitive advantages more effectively. Hence, ESG strategy consistency within the organisation is key[94].

For companies, building credibility and consistency is key to achieving a sustainable competitive advantage. As ESG performance is being scrutinised by an ever-growing number of stakeholders such as investors, regulators and NGOs, even a few inconsistencies between words and deeds can have severe reputational consequences. In the financialized ESG system, reputational risks materialise instantaneously in the form of rating agency downgrades, divestments and exclusion from sustainability indices[95]. Achieving a sustainable competitive advantage in ESG is not about having a few ESG moments of publicity, but about having a credible and consistent set of actions that are in line with company statements. All in all, ESG on its own does not create value, it is the playground and the rules of the game where companies can build value, as long as the right market conditions are met, company capabilities are developed, and the regulatory and long term capital structures are favourable. Achieving a sustainable competitive advantage in ESG however also comes with its downsides, such as the case of companies having to bear high costs to customers without any tangible benefit, or managers having to carry out insignificant and time-consuming compliance activities with little to no tangible impact, or that companies are heavily focused on measuring and setting targets with little to no lasting impact on their business model and operations.

The Section on Conditional ESG Advantage delves into the inherent constraints of a metric-driven ESG approach and the unintended consequences of using universally accepted ESG metrics that can create incentives that are counter to real sustainability improvements. However, before exploring these complexities, it is important to appreciate the nuances of the term "sustainability". While the term is widely used, there are at least two distinct meanings, namely: • Sustainability as a means of achieving renewal within an organisation through tangible, lasting transformations; • Sustainability as a means of enhancing an organisation's image and achieving a conditional ESG advantage.

4.3 Strategic Limits of Metric-Driven ESG

As we mentioned on our last posts, we focused on the strategic integration of ESG in the context of the transition to a sustainable economy. This post is focused on whether companies will have to adapt their business models or just report exogenous variables that come as a result of that transition. As mentioned in our previous post about the management of ESG risks in the context of sustainable

[93] G. A. Epstein, 2005; A. Edmans, 2022.
[94] D. J. Teece et al., 1997.
[95] F. Berg et al., 2022; D. M. Christensen et al., 2022.

economy, a real strategic approach to ESG is complicated by the fact that current practices are based on a financial model using ESG criteria, indicators and key performance indicators that focus mainly on the external social and environmental and governance impact of companies. We have been talking about the 'financialisation' of ESG issues, focusing on the use of a quantitative and benchmarking methodology with the aim of ensuring higher comparability and transparency of companies' performance based on these criteria[96]. But it also has its drawbacks, and the measurement of the ESG performance of companies, which is important to ensure greater transparency and good governance of the management of external social, environmental and corporate governance impacts, leads to companies competing with one another to achieve better ratings and performance indices in order to gain greater prestige, have access to better resources and be considered leaders in terms of sustainability in their sector. However, focusing on measuring ESG performance leads to the same limitations as in the economic and financial field, in the sense that companies tend to focus on those issues that are easiest to quantify and measure[97], such as their ESG ratings, or the benchmarking indicators of the reporting frameworks for sustainability such as GRI or the Global Sustainability Reporting Guidelines, or their KPIs, and there is little incentive to invest in carrying out the fundamental work needed to achieve improvements in sustainability at the business model level. The main focus of companies is still the reporting process, improving their disclosure practices, implementing codes of conduct and audit processes for the responsible management of external social, environmental and corporate governance impacts. And although it is essential that companies carry out work that is transformative in relation to their business models in order to achieve a real change in their sustainability performance, this type of change often requires very long term investments and it is not easy to measure the positive impacts that they have, which are therefore not often reflected in the ESG scores that companies achieve.

Share prices respond to reporting objectives but are assessed against assessment objectives This creates a strategic substitution effect. With so many opportunities to choose from when it comes to discretionary investments, companies may decide not to undertake reforms and instead work to improve their image and their ratings. Therefore, more disclosure, more comprehensive sustainability reporting and better information technologies can all be used to boost the ESG ratings of companies, whatever the impact on their business models. Companies can carry on as if the metrics that form the basis of the assessment of their performance are the definition of sustainability. Rather than being a question of the companies' level of commitment to sustainability, the substitution effect is a direct consequence of the rules of the ESG regime. Companies have the choice of adapting the metrics in order to optimise their performance and gain access to financial markets, reassure investors and ensure the continuity of their funding. In this respect, optimising the metrics that form the basis of the assessment of their ESG performance can be a completely rational strategy for companies, since it does not necessarily require any profound restructuring of their business models, and therefore no long-term changes for sustainable development.

One of the key strategic limitations of the metric-based version of ESG is probably the tension between quantitative efficiency and qualitative transformation. While measurement is a condition for being able to govern companies within the framework of a regime of accountability established for

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[96] R. Shamir, 2008; E. Pollman, 2022.
[97] F. Berg et al., 2022.

them, it can lead to undermining the qualitative character of sustainability by transforming the goal of measuring the very purpose of sustainable action. Rather than giving up measuring altogether, one has to take into account its effects on managers and how measurement can turn into a determining factor in the management of companies, modifying manager's goals in ways that are not necessarily foreseeable.

ESG issues are increasingly in the spotlight, particularly when it comes to the way companies behave and interact with stakeholders. One of the most visible manifestations of this trend is the integration of ESG indicators into the variable compensation of executives, which is a subject that has been discussed for several years. Many companies have started to link a percentage of the variable salary of their executives to the achievement of specific sustainability performance indicators such as: reduction of CO2 emissions, diversity, workplace accidents, or governance. In theory, this should provide a major governance lever to make sure that the executives are responsible for the performance of their companies in terms of sustainability[98].

The concept of tying ESG metrics to executive compensation is a widely accepted and laudable idea, but there are many things to think about. Most compensation plans have Key Performance Indicators or KPIs, measurement periods, and target values or ranges for each performance metric. In order to meet these requirements, companies are likely to report on the ESG metrics that are easiest to measure and report in a comparable fashion. There are different types of ESG issues that a company managements want to address, and some may be easier to measure and report upon than others. For example, using widely-accepted industry standards, and focusing on shorter-term metrics which are easier to measure and report may be easier than trying to address some of the longer-term, qualitative issues, where measurement and attribution may be difficult. This distortion in measuring key performance indicators could be termed KPI distortion. The purpose of the key performance indicators is to provide incentives for management to act in certain ways, and by including specific ESG metrics in the performance goals of management, management will naturally focus as much as possible on these metrics to achieve their compensation targets. So while the company may generally wish to reduce its carbon footprint as an overarching goal, management will tend to achieve the specific target set for carbon footprint reduction, such as reducing the carbon footprint per unit of production as measured by a baseline of a certain level of production (and may therefore have an incentive to reduce the level of production as well in order to achieve the reduction in the carbon footprint per unit of production) rather than trying to reduce the overall level of production or otherwise consider the overall impact of achieving the carbon footprint reduction target in the context of the company's business. Likewise, while the company may want to generally improve diversity within the workforce, management may only be focused on increasing the percentage of women in the workforce, and in order to meet the target will strive to maximize the reported percentage (through activities like appointing diversity champions, reporting on diversity training etc.). The goal of the metric itself can therefore take on a life of its own and become the objective to be achieved, rather than an intermediate measure used to achieve the greater goal of the company[99].

A further challenge is that ESG-linked incentives are often provided through short to medium term arrangements. Whilst many companies set out multi-year ESG goals and objectives, the pay and

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[98] L. A. Bebchuk, R. Tallarita, 2020.
[99] A. Edmans, 2022.

tenure arrangements to address long-term executive incentives are generally shorter term in nature. This leads to a short-term focus being introduced in respect of ESG issues in order to qualify for any ESG-linked bonuses. Long term sustainability change may not be encouraged, as the benefits may not accrue to the current crop of executives[100]. This is not necessarily a change management issue, as such, but more a reflection that the inclusion of ESG into short-term pay practices has not given rise to any significant adjustments to executive pay to reflect the long-term nature of sustainability issues.

ESG incentives are not a bad idea in principle, but the way in which they reduce a complex ESG issue to a relatively simple measurement criteria can turn a very strategic decision into a very administrative and perhaps even less than optimal choice. The more complex and qualitative the goal, the more difficult it is to measure and the more what is measured ends up becoming more important than what is not. The ESG governance paradox is just another expression of this more general problem. On the one hand, taking ESG into account in the governance of a company can serve to enhance the level of accountability of corporate managers, and can also send an important signal in relation to the firm's engagement with sustainability. However, this can be done in a way that exacerbates other problems that undermine the meaning of ESG. There is a risk that companies incorporate sustainability into their governance structures as a way in which managers can obtain larger bonuses from shareholders and rating agencies, by meeting sustainability targets. In other words, sustainability ends up being a way in which managers are able to maximise their gains from their relationship with shareholders and ratings agencies, rather than an opportunity for the firm to come up with new ideas for the future that are different from the standard and perhaps uninnovative approaches that currently prevail in the market. There is therefore a trade-off to be struck in relation to governance and accountability in the context of sustainability and the firm. We need to include sustainability in governance in order to prevent it from being ignored as a variable. But at the same time we need to be wary of reducing the scope of managerial discretion as a way of enhancing the level of accountability and signalling a firm's engagement with sustainability.

Another constraint of the metric approach to ESG is that the relationship between the ESG assessment processes and the time scales of the capital markets is not yet well understood. ESG is indeed presented as a paradigm of long-term value creation but the ESG metrics are assessed on much shorter terms corresponding to the quarterly results, performance benchmarks and the permanent monitoring of investors. This contrast between the long-term dimension of sustainability and the short-term dimension of the capital markets is a major strategic constraint[101].

This post was written by Lukas Roth and Svenja Schroder. The pressure on companies to deliver on short-term interests is rising. This pressure is exacerbated by the short-term focus in financial markets and, in particular, by the financialized ESG regime. It is characterized by rating changes which are revised on a quarterly basis at the latest, ESG indices that are re-weighted annually, and where investors are preoccupied with comparing their own portfolio performance to that of their peers. Companies are under significant pressure to generate short-term ESG progress[102]. This pressure has given rise to short-term ESG activities that can achieve ESG progress in the here and now, such as by providing more and better quality information, presenting more comprehensive and detailed

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[100] L. A. Bebchuk, R. Tallarita, 2020; A. Edmans, 2022.
[101] G. A. Epstein, 2005; R. Shamir, 2008.
[102] F. Berg et al., 2022.

sustainability reports, including sustainability policies, achieving ESG targets, among other things. These activities can lead to immediate improvements in ESG reporting and consequently to an improvement in ESG ratings. On the other hand, long-term sustainability transformations such as digitalisation, re-shoring or retrofitting capital intensive assets such as factories or buildings require more time to generate tangible ESG progress and are often associated with short-term costs. Therefore, companies may be inclined to allocate more investments to short-term ESG activities in order to meet the short-term expectations of large numbers of scrutinizers in the markets. While these activities are not necessarily negligible, they are often chosen because they can enhance the company's image in the markets and are therefore considered worthwhile. The financial markets have created a new focal point for company management.

Amplification of reputational risks caused by the financialisation of ESG The financialisation of ESG can also lead to more short-term market fluctuations in the wake of more temporary events or less serious deviations from the norm. Any ESG-related incident, whether it be an environmental spill, a governance issue or a social media scandal, can cause a company’s ESG ratings to be changed immediately, attract the attention of the media and prompt shareholders to sell their shares[103]. In order to mitigate the reputational damage and avoid drawing even more attention to the affair, companies may decide to implement risk management and reputation management measures. Although these measures are essential in their own right, they can serve as a distraction for managers, preventing them from focusing on the long-term, strategic and value-creating activities that are essential to a company’s performance.

Temporal tension in financialized ESG is a more general structural feature. The aim of sustainability transition policy is to bring about profound changes in the economy in the long run. This will require experimentation with potentially inefficient and costly arrangements in the short run, while the economy is in a transition phase to a new state. In contrast, financial markets can only reward short-term, tangible evidence of successful ESG implementation and punish uncertainty. Companies therefore have to navigate a tightrope between safeguarding short-term ESG legitimacy and investing in their long-term sustainability goals. It is not impossible to reconcile the market economy and financial markets with the objective of achieving sustainability, it is rather a matter of time consistency. Patient capital, stable shareholdings and long-term-oriented boards of management are all important factors in enabling companies to balance their ESG objectives with the requirements of the financial markets. Companies under pressure to deliver immediate profits to shareholders and other stakeholders will generally have fewer opportunities to realise their sustainability commitments in meaningful structural changes.

However brief capital market time may be, the weight of ESG rating systems imposes a constraint on the freedom of companies' managers to choose the best options for the strategic reconstruction of their firms. Within the context of the central paradox of financialized responsibility – that of transforming economic issues into market-based market issues while simultaneously subjecting the very market to the discipline of the shortest possible time horizon, which paralyzes reflexivity and the time needed to carry out profound structural transformations to the business model.

[103] D. M. Christensen et al., 2022.

The politics of exclusion and control discussed in part one and the strategy of homogenization discussed in part two are both relevant to the institutional arrangements arising from the implementation of the EU taxonomy and the increasing use of ESG ratings. The latter are designed to provide a series of metrics such as disclosure frameworks and scores that enable stakeholders to make informed assessments about companies. These 'instruments' can be seen as being used for two distinct purposes: First, as a means to facilitate the politics of exclusion and control, in this case the metrics would enable effective market evaluation and as such would be an instrumental use of these disclosure frameworks and other frameworks and scoring systems. Second, in a more strategic sense, the use of these frameworks can act as a mechanism of standardisation. Thus when companies are assessed against a common framework, be it through the EU taxonomy, the use of the same ratings agency or the use of leading practices that are identified by one or more rating agencies, then companies are incentivised to conform to a common benchmark and practice[104]. As there are no products, or technologies, or unique skills that companies compete on, and the unique selling proposition or resource bundles are rarely ESG related, companies are then driven to compete in terms of the standards of business conduct that are recognised by the market. In the same way companies have an incentive to follow and abide by the provisions of a standardised code of business conduct, companies have an incentive to follow similar disclosure frameworks and declare that they are following similar sustainability standards (such as net zero). Achieving such legitimacy is seen to open up access to new forms of non-market profit such as social licences and the like, as well as market profit. Sustainability is not about enabling a company to renew and improve its position in the market place, it is about achieving an entrance ticket for companies to access those benefits and as such is far removed from being a competitive business strategy in the form of a basis for competitive renewal and improvement and hence growth.

Several other problems related to regulatory taxonomies and disclosure requirements are not yet addressed in the literature. On the one hand, standards and mandatory disclosure are essential for reducing information asymmetry. On the other hand, framing sustainability solely on the basis of external criteria can mean that the strategic horizon of companies is curtailed: instead of asking how the business model or value proposition can be changed in order to take account of the requirements of sustainability, companies start to ask which methods they can use in order to meet the regulatory criteria for disclosure that are defined by the reporting categories introduced by regulatory authorities. In other words, what we have here is a conformity-based approach rather than one that is driven by innovation[105]. On the one hand, the use of regulatory taxonomies and disclosure requirements is important for achieving transparency and efficient market operation, and for enabling investors to compare the sustainability performance of different companies. On the other hand, it can stifle the scope for firms to carry out strategic experimentation while at the same time achieving stability of ratings. Firms that treat ESG as no more than a compliance checklist will achieve stability of their ratings, but they will not be able to implement the dynamic changes to their business models that are needed for real sustainability. The strategic limit of a metric-driven ESG approach is to be able to reduce sustainability to a compliance framework that is more focused on making things comparable than on leaving room for creativity. And the more companies compete on the same metrics, the more their differences will be considered negligible. Sustainability will become a minimum condition for

[104]E. Pollman, 2022.
[105] Regulation (EU) 2020/852 (EU Taxonomy Regulation); Regulation (EU) 2019/2088 (SFDR).

participating in the market, but not a factor in achieving performance[106]. The strategic question will no longer be about improving the ESG score, but about changing the competitive business model by integrating sustainability as a central element.

This chapter will lay the groundwork for our future analyses of sustainability in the years to come. We have seen how the financialisation of ESG has succeeded in turning sustainability into a market and a governance issue. But having something on the markets or in the governance structures of organisations is not the same as having an impact on the long term strategy of companies and economies. Achieving convergence and efficiency by referencing standards and benchmarks is not enough when one has a critical perspective on the convergence logic, as we have. In order for companies to exit this logic, they will have to navigate a new world of competitive sustainability, in which their long-term strategic autonomy is called into question. This concept of competitive sustainability represents the possibility of having one's cake and eating it too. In other words, companies must ensure that they are under the necessary market pressure to meet the demands of the new era of sustainability, while also preserving their ability to sustain and improve their competitive advantages over time[107].

This third chapter aims to advance our understanding of the strategic importance of ESG. As has been illustrated in the first three chapters, the ESG issue is not on/off. Rather, it is deeply embedded in the socio-economic context of the 21st century, which has led to the financialization of sustainability, endowing ESG with a unique strategic character. ESG has moved beyond the traditional CSR discourse and has evolved into a central governance, investment and strategic issue for firms, which are therefore forced to 'sustainability-ise' their daily operations. Paradoxically, the very mechanisms that increase the economic importance of sustainability also create distortions. Metric optimisation, incentive simplification, short-term visibility and standardisation all hinder deeper transformation. The discipline brought by financialised ESG is not the same as renewal. The correspondence between sustainability metrics and the long-term economic value created by companies remains a conditional and highly heterogeneous fact.

I view the ESG challenge less about whether the concept of ESG is valid and more about whether it is framed and constructed in such a way as to provide companies with sustainable competitive advantage, that is sustainable, distinctive and lasting. ESG can only have a transformative impact on the global economy if people begin to consider sustainability a serious business issue and not a regulatory or market ratings issue. If companies can tie ESG to their unique value proposition and long term strategy, then sustainability can create a competitive advantage that helps build business and consumer resilience and facilitate greater and more sustainable innovation.

We are no longer wondering how companies can comply with the ESG norms, but rather how to liberate them from the metrics that have become a barrier to truly integrating sustainability into their competitive strategy. This chapter will look in more detail at the competitive sustainability approach, through the prism of financial constraint as a resource for creating a long-term competitive differentiator.

[106] G. R. Krippner, 2005.
[107] M. E. Porter, M. R. Kramer, 2011; J. Barney, 1991.

5. Chapter IV – Beyond Financialized ESG: Towards Competitive Sustainability

5.1 ESG at a Crossroads

In the last ten years ESG has reached a level of institutionalisation that marks a clear difference to the other phases of the history of corporate responsibility. ESG is no longer the spontaneous and fragmented set of initiatives it was in the other phases: it has been formally incorporated into capital markets, into the regulatory system and into corporate governance. The disclosure recommendations of the TCFD, the EU taxonomy for sustainable activities and the legislative confirmation of the NF regulation have all combined to transform the ESG principle from a moral duty into a fully-fledged governance system[108].

This institutionalization represents a significant structural achievement. Sustainability considerations are no longer peripheral to corporate evaluation but integrated into the mechanisms through which firms access capital, maintain investor confidence, and position themselves within competitive markets. The incorporation of ESG into risk assessment models, asset pricing mechanisms, and executive incentive structures has transformed corporate responsibility into an economically consequential variable. In this respect, ESG has succeeded in narrowing the historical divide between ethical aspiration and financial logic[109].In addition to the many benefits derived from ESG, it has also led to a kind of linguistic and cognitive convergence in relation to sustainable development at the global level. The use of indicators and disclosure standards has enabled the comparison of more comprehensive disclosures made by companies. Therefore, investors, public authorities and other stakeholders can more easily compare the performance of companies operating in the same market within the framework of a similar evaluation framework. The standardisation of disclosure standards, which has contributed to greater transparency and the reduction of discretionary opacity, should not be ignored either[110]. In any case, ESG cannot be limited to being a mere fig-leaf or an act of moralism, devoid of any real impact on the integration of sustainable development into market economy mechanisms.

It is possible that an institution can be mature, but a company does not have a complete strategy. On the one hand, the incorporation of ESG criteria into the financial and regulatory systems has made it clearer and more operational what the criteria are for measuring and assessing the sustainability of companies. On the other hand, it is not yet clear that the ESG system is fully adequate to deal with the challenge of integrating sustainability into the specific business model of a company. It is no longer a matter of debate as to whether sustainability has an economic impact. The impact has been demonstrated. The challenge is to know if the current ESG system is sufficient to allow companies to carry out the profound transformation needed to remain competitive in the long term.

[108] Regulation (EU) 2020/852 (EU Taxonomy); Regulation (EU) 2019/2088 (SFDR); Directive 2014/95/EU (NFRD); Directive (EU) 2022/2464 (CSRD); Task Force on Climate-related Financial Disclosures (TCFD), Recommendations, 2017.
[109] G. Giese et al., "Foundations of ESG Investing", Journal of Portfolio Management, 2019; S. L. Gillan, A. Koch, L. T. Starks, 2021.
[110] F. Berg et al., 2022.

With the increasing institutionalization of ESG processes within the governance of public companies, a true paradox has arisen. The reduction of complexity to facilitate comparison between business actions addressing environmental and social issues is not unimportant to anyone who examines the characteristics of the actions that have translated these into quantitative terms, adapting them to the market context. The scope of sustainability issues is, in fact, reduced to the dimensions necessary for their transmission to the market and evaluation[111]. The objective is to pursue a financial governance process that bases its decisions on the principles of: a) comparability; b) data aggregation; c) evaluation of business action strategies. To ensure the full inclusion of sustainability issues in financial market governance processes, it is therefore necessary to reduce the complexity of these issues and transform them into numbers, metrics, and rankings. Rating agencies, ESG index providers, and regulators also adhere to this process of functional reduction of complexity, since the detailed reduction of the complexity of environmental and social issues and their transformation into ESG indicators leads to their reduction to an all-time low and therefore a simplification of CSR that does not allow for any plurality of interpretations[112].

In our system there is a paradox at play. On one side there is the multi-dimensional sustainability reality and on the other side one-dimensional evaluation. Our low-carbon economy, biodiversity conservation, greater equality and transformed global value chains are all complex, dynamic systems. They are all deeply connected with the environment and the social context in which they operate. Their effects are widespread, long-term and may involve many non-linear and interacting effects. This makes it difficult to convert these complex effects into the simplified ESG metrics that are requested by the capital and consumer markets[113].

This is not simply a matter of technology. It has serious strategic consequences. Organizations exist within systems of evaluation. If those systems define the performance of organizations in terms of, say, ‘carbon emissions’, ‘gender diversity’ and ‘corporate social responsibility reporting practices’, those are the standards to which organizations will be held. Other forms of sustainability, forms that are qualitative, dynamic, forward-looking and context-dependent, are left behind. Financialized ESG is not just about measuring and commenting on the social and environmental responsibility of organizations. It organizes the very terms of those organizations being responsible[114]. The paradox is intrinsic and not accidental. It is the result of designing ESG as a system to integrate sustainability into the economy. The process of integration involves a streamlining and normalization of the economic function that is incompatible with the experimental and transformative nature of the change in structures required for sustainable development[115]. Financialized sustainability has a role to play in increasing the degree of economic accountability. But it can also reduce the space for experimentation and limit the horizon of strategic thinking and innovation.

There is no way to escape the paradox, but accepting it does not necessarily mean that measurement and regulatory compliance are off the table. On the contrary, any regulatory system that tries to establish benchmarks and penalties necessarily implies the possibility of measuring and controlling

[111] R. Shamir, “The Age of Responsibilization”, 2008; W. N. Espeland, M. L. Stevens, “Commensuration as a Social Process”, Annual Review of Sociology, 1998.
[112] F. Berg et al., 2022; D. M. Christensen et al., 2022.
[113] E. Pollman, 2022.
[114] G. A. Epstein, 2005.
[115] G. R. Krippner, 2005.

those benchmarks and penalties in order to ensure maximum transparency for the purpose of meeting the expectations of shareholders and investors. The paradox is not necessarily about measurement, but rather the fact that as soon as we accept the idea that ESG criteria provide a complete and exhaustive vision of a company's social and environmental performance, we inevitably restrict our field of view. And the more a system is designed to increase external discipline, the less it is likely to promote an innovative and open form of corporate governance.

ESG has long been associated with a structural paradox that is further exacerbated at the level of corporate strategy. Most firms operate in a context where the performance of their sustainable activities is subject to intense scrutiny, monitoring and benchmarking, and where ESG data is compared to that of competitors. ESG rating providers, disclosure requirements, regulatory labels, etc., can serve as a framework for defining the legitimate and acceptable boundaries of ESG performance for investors and regulatory bodies[116]. And while these measures can be very useful, they tend to focus the attention of corporate managers on two aspects of ESG practices.

There is a certain inherent tension to the UNEP FI flagship report. On the one hand, the underlying premise of ESG is to ensure that companies incorporate sustainability into their governance, investment and risk management practices. On the other hand, the use of a common set of metrics, such as those provided by the Global Reporting Initiative (GRI), may lead to a convergence of sustainability practices within an industry along sector specific lines, thereby imposing a one-size-fits-all approach to sustainability that constrains diverse business models. Thus, the advantage of conforming to widely recognized benchmarks and best practices for sustainability may dominate the consideration of alternative approaches to sustainability[117].

Companies are not indifferent to the subject of sustainability. What worries me is that they will resort to standardized tools to obtain external ratings or certificates in order to demonstrate their social responsibility. In the history of competitive strategy, companies have always had unique competitive advantages, developed specific skills and abilities internally, established particular organizational structures to respond to specific situations and occupied specific positions on the market. If companies adopt the same approach to sustainability, sustainability criteria will simply become a series of criteria assessed by external rating agencies in order to guarantee the social responsibility of the companies, and not to influence their competitive strategy[118]. Time horizon of financialized ESG is also limited by market constraints that do not enable radical change. Achieving structural sustainability transitions like reducing carbon emissions in production processes, reengineering global value chains or investing in new technologies require access to stable, long-term capital and a willingness to accept short-term inefficiencies during the transition period[119]. Those who work towards sustainable change are under pressure to ensure that they have sufficient short-term legitimacy and are able to raise sufficient capital in order to achieve their long-term goals.

There are quite a number of pressure points in the system which suggest that ESG is at a tipping point. On the one hand the institutions of the ESG system, its economic impact and the formalisation of

[116] F. Berg et al., 2022; Regulation (EU) 2019/2088 (SFDR).
[117] United Nations Environment Programme Finance Initiative (UNEP FI), Principles for Responsible Investment (PRI); Global Reporting Initiative (GRI), Sustainability Reporting Standards.
[118] J. Barney, 1991; M. E. Porter, 1985.
[119] G. A. Epstein, 2005; A. Edmans, 2022.

regulation all point to a system with real and enduring influence over the firm. But for the sustainability agenda to move forward, the ESG system needs to shift from being a top down mechanism to a bottom up system, in other words the firm needs to become the key actor in its own affairs, and rather than being an external set of standards, environmental, social and governance issues need to be seen for what they have always been, a design parameter for the future business models and competitive advantage of the firm.

The idea of competitive sustainability is central to this debate. Rather than competing with financialized ESG, competitive sustainability surpasses this concept by founding sustainability on the capabilities of the firm, its long term capital structure and sources of strategic rent. This chapter further explores the components of competitive sustainability, and the ethical, political and economic consequences that may ensue. In order to be able to work with the tensions identified it is necessary to set them in the context of the change in current capitalism under conditions of financialization. Today, the criteria for company assessment are market and share value criteria, shareholder expectations and the risk adjusted return (RAROC) methodology. Sustainability has not been developed in a context other than this one. Rather, it has been integrated into it. Sustainability criteria are assessed with the same methods, criteria and assessment instruments that companies use for their financial results. In this way the market discipline is maintained and reinforced with a market-oriented character and that companies are judged by an economic criterion.

The embedding of market-based incentives in the governance of sustainable development has been viewed both as a remarkable success and as an enormous challenge. On the one hand, market-based instruments are seen to have finally bridged the once seemingly insurmountable divide between social and environmental responsibility and profit. On the other hand, such market-based incentives have removed a number of crucial strategic business decisions from the internal politics of the firm, and placed them in the hands of external evaluators like market ratings agencies, institutional investors and regulatory agencies, whose standards and benchmarks bear little relation to the company's unique situation or the scope for action which is open to it. The financialization of ESG in this sense increases the incentives and reduces the autonomy of the firm. The firms are ranked and benchmarked in a busy evaluation arena and are required to pursue common goals that are set by the sustainability evaluation regime. While providing the means to evaluate and enforce sustainability on a comparable basis, it severely restricts managerial discretion to attempt to introduce innovative approaches to sustainable development. In this context, the firm's strategic actions are directed at the goal of securing evaluation approval from evaluation agencies. Instead of enabling firms to redefine competitive success, it becomes a matter of achieving external approval of their actions in order to be seen as an efficient and ethical organisation.

In my opinion, there is an inherent limit to financialized forms of sustainability. ESG has clearly brought sustainability into the world of finance, but having sustainability be "economic" and therefore "important" is a far cry from bringing through real change. And when one reflects that all that is required for sustainability compliance and for market leadership in terms of ESG practice is that appropriate data is collected, that the right systems are put in place and that the right ratings are achieved, then it is clear that financialized forms of sustainability will play a large role in reinforcing current systems whether or not they are changed at the level of behaviour.

The question is not if ESG is maintained. The question is whether current practices help firms to achieve their strategic sustainability goals. To address this question we need to reframe the discourse that brings us back from market based discipline as the main governance mechanism to firms exerting strategic agency and hence taking back control over their own affairs. This section attempts to set out a framework for competitive sustainability.

5.2 Defining Competitive Sustainability

For a company to be competitive in terms of sustainability, the challenges it faces must be fully integrated into its core competences, capital structure and business strategy. This is very different from merely complying with ESG criteria or benchmarking against market-wide industry standards and ratings systems. Achieving competitive sustainability is not about meeting these market standards of ESG performance. Rather, it is about integrating sustainability into the very heart of the company's business model and processes for innovation, as well as into investment and spending decisions and the firm's value propositions[120].

There are two types of ESG practices, namely "financialized ESG" and "competitive sustainability". The former is external-oriented and competitive sustainability is internal-oriented. "Financialized ESG" refers to the practices of companies which adapt to rating methodologies, disclosure standards, investors' preferences and regulatory labels. "Competitive sustainability" refers to practices that are based on the resource base, technology, organization and overall strategy of a firm. In the latter approach, sustainability is not a set of rules that companies have to follow but a set of variables that they can negotiate in order to ensure their competitiveness[121].

ESG infrastructure is not eliminated, but redefined. ESG metrics, disclosure standards and regulatory classifications are seen as boundary conditions rather than as a set of strategic objectives. In a competitive sustainability framework, achieving compliance with ESG standards is a necessary condition to preserve legitimacy and access to capital markets. However, it is not sufficient to ensure sustainable competitiveness. The strategic question is no longer "How can we improve our ESG score?" but "How can we leverage sustainability to reinvent our competitive advantage?"

Firms have to fulfill three key principles in order to be competitive in relation to sustainability. The first principle is that the principle of sustainability has to be integrated into the capability architecture of a firm in order to impact the evolution and use of its assets. The second principle is that the principle of sustainability has to be incorporated into the strategic capital budgeting process, as opposed to it being only an annual reporting event. The third principle is that the principle of competitive sustainability should also have a strategic benefit to the firm in the form of increasing the firm's strategic uniqueness and its ability to differentiate itself from its competitors rather than resulting in the firm becoming a carbon clone of its competitors with each firm reducing itself to a minimum common denominator of regulatory compliance[122].

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[120] M. E. Porter, M. R. Kramer, 2011; S. L. Hart, 1995.
[121] G. A. Epstein, 2005; E. Pollman, 2022.
[122] D. J. Teece et al., 1997; M. E. Porter, 1985.

The term competitive sustainability is important in this discussion. Competitive sustainability does not mean that every effort to achieve sustainability will be competitive. Sustainable competitive advantage will only be achieved when the firm is able to connect the sustainable aspects of products and processes to areas of tangible competitive strength. In this way, sustainability becomes a strategic dimension in and of itself and is not just a tactical overlay[123].

In this sense, competitive sustainability is not far from ESG, but rather the natural evolution of the financialization of ESG that is underway. While financialized ESG has empowered markets to integrate social and environmental responsibility into market pricing mechanisms, competitive sustainability brings responsible economics into the internal workings of companies. In other words, competitive sustainability solves the conundrum created by the pressure to make ESG and sustainability reporting disclosed and accountable on the one hand, and to maintain a competitive internal pricing system for business activities on the other. It becomes necessary to align the sustainability of a company to not only the financial materiality that is determined on a short term basis, but also to the future competitive structure of the business.

As the first element of competitive sustainability, the environmental and social dimension has to be included in the competence structure of the firm. As is well known in the literature of strategic management, any firm has the chance to be competitive if it possesses rare and difficult to imitate resources and abilities. Therefore, it is the competence of firms to incorporate the dimension of sustainability to their key competences and not to view it as a constraint[124]. In the world of financialized ESG, we commonly measure the relative sustainability of companies versus their competitors. Metrics are used to create a level playing field among companies, and to encourage all firms to embrace similar practices. While there is a large scope for potential capability-based differentiation between firms (eg by industry, technology, and position in the market), the reality is that companies operate in different sectors, are at different stages of technological development, and occupy different market positions[125]. A renewable energy firm's sustainability strategy will differ from that of a diversified manufacturing conglomerate and from that of a high-tech, digital platform company. In order to achieve competitive sustainability, we therefore need to move beyond the one-size-fits-all approach and strive for a more holistic form of strategic integration[126].

I am arguing that a firm has sustainable capabilities if sustainability is built into its capability architecture. This means that, in some respect, environmental and social factors impact the formation and transformation of firm capabilities. In other words, the concepts of sustainability and sustainable may be introduced within the capacity building dimension of policy. For example, a low-carbon process innovation investment could embed a trajectory of sustainability in the firm's R&D competence, hence forming a competence based on some combination of proprietary technological knowledge and sustainable production methods. Conversely, a firm reengineering its global supply chains in order to obtain traceability and to secure sustainable sourcing of materials would develop

[123] J. Barney, 1991.
[124] J. Barney, 1991; D. J. Teece, 2007.
[125] J. Barney, 1991; M. E. Porter, 1985.
[126] E. Pollman, 2022; F. Berg et al., 2022.

social relational capabilities of prime importance to its future supply relations[127]. In this context sustainability is a policy capacity building one.

Sustainability is often seen as a administrative cost and therefore does not seem to be a source of strategic dynamics. However, by integrating sustainability into the learning, cross-functional cooperation and experimentation processes of an organization, it is possible to increase the organization's capacity to handle uncertainty, a resource that is becoming increasingly important in a more turbulent and volatile world. Being able to read and act on signals from the external environment, such as those generated by environmental transition pressures, can also be a competitive resource[128]. To achieve a capability-based differentiation of sustainability strategies it is necessary that these strategies are strategically consistent. In relation to the core competences of a company and its future strategy, a company should not carry out sustainability activities as a 'ratings' exercise. If a company's sustainability investments do not support its core competences and strategy, they will not achieve a real competitive benefit but at best a window-dressing effect for visibility. Therefore, the concept of competitive sustainability must be strategy-based[129].

The concept of competitive sustainability overcomes the ability-based approach to sustainability and the ESG compliance-based approach. The ability-based approach is driven by the compliance logic, which confines sustainability to the periphery of the firm. The ESG compliance-based approach is a competitive concept, as firms operate under the external evaluations and ratings imposed by third parties. Through competitive sustainability, a firm determines and steers its own competitive path, no longer being bound by external ESG-accounts. As a result, it harvests the benefits of the ESG-accounts, while at the same time maintaining a connection to sustainability and avoiding the uniformity and predictability inherent to the ESG standards and practices that firms have to adhere to in order to receive a rating from third parties.

The second sustainability pillar is linked to the alignment of sustainability and long term capital structure. Capability-based differentiation is related to the competitive aspect of sustainability, capital structure is related to the investment aspect. It is the way capital is invested, the way risks are measured and the time horizon related to expected returns that will decide about the nature of the sustainable transition of the companies[130].

Today's ESG system within the financialized economy turns sustainability into a risk management and reporting business. Companies publish their transition plans, their emissions reduction targets and their governance practices. Investors are also integrating ESG risks into their pricing models. Yet disclosure alone does not lead to meaningful changes in the way companies invest their capital. For sustainability to impact the competitive advantage of companies, ESG factors must be included in the decision-making process for investments related to capital expenditures, research and development, mergers and acquisitions or divestments[131].

Long term capital structure refers to the firm's organisational structure that determines how the firm decides to allocate capital across different time periods. It refers to issues such as capital budgeting

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[127] D. J. Teece et al., 1997; S. L. Hart, 1995.
[128] D. J. Teece, 2007.
[129] M. E. Porter, M. R. Kramer, 2006.
[130] G. A. Epstein, 2005.
[131] S. El Ghoul et al., 2011; G. Friede, T. Busch, A. Bassen, 2015.

and discount rates, decision models for investment and financing options, balance between short term and long term and so on. Integrating sustainability in the long term capital structure means that the assessment of transition risks and resource scarcity as well as social impact are built into the investment decisions rather than being simply presented in the ESG reports[132].

For a company to be truly "committed" to decarbonisation, its disclosure of emission reduction targets in its sustainability reports must be matched by capital expenditure that is consistent with the transition it is engaging with. This means that companies will have to stop investing in assets that are incompatible with a low-carbon economy and instead invest in renewable energy, network electrification and the circular economy. This may lead to a short-term fall in profitability and possibly even write downs of assets. However, it is crucial for the long-term strategic viability of the company. Competitive sustainability demands temporal consistency between a company's sustainability goals and capital expenditure decisions[133]. It also requires an appropriate capital structure. Companies with highly indebted capital structures and short-term oriented shareholders are unlikely to be able to afford to invest in the transformational assets required to achieve competitive sustainability. Conversely, companies with long-term oriented shareholders, long-term institutional investors and long-term corporate governance are more likely to be able to align their sustainability goals with their capital structure. Competitive sustainability is therefore at least to some extent a matter of the right capital and ownership structure[134].

So far we have concentrated on the capital structure decision made by the firm. In this subsection we consider why sustainability should be included in the capital structure. It is unlikely that firms will bring in sustainable technologies as a result of improving their ESG ratings because of the negative effects described in previous chapters due to the substitution effect. Also, the decision regarding the capital structure is a structural one, and is not easy to reverse. This decision will significantly affect the firm's capability development over many years, and we would not wish the firm's capital structure to change in ways that are not consistent with the competitive sustainability principles. Any gains from better disclosure, and the incremental improvements to KPIs that result in a higher ESG score are likely to be short-term. They are unlikely to reflect fundamental changes in a firm's capital structure. Long-term capital structure is at the very heart of competitive sustainability. It constitutes a major institution of sustainability that integrates the latter into the time horizon and identity of the firm and that thus affects the forms of organization of production and of accounts, and finally the accumulation of productive capital[135].

On 4 October 2023, the 14th Global Competitiveness Forum (GCF14) took place at the Paul Schiller Arena, where the central theme was "Thriving in a Turbulent Future: Strengthening Societies to Compete and Succeed". The Körber Foundation hosted the event in close cooperation with the World Economic Forum. As part of the GCF14 report, the third dimension of competitive sustainability was examined, focusing on the alignment of governance systems and incentives. In the previous chapters, we dealt with the issue of including ESG criteria in the remuneration and reporting of company management to increase transparency and encourage responsible corporate governance. However, as

[132] A. Edmans, 2022.
[133] C. Revelli, J. L. Viviani, 2015.
[134] A. Edmans, 2022; L. A. Bebchuk, R. Tallarita, 2020; C. Mayer, "Valuing the Invaluable: How Much is the Planet Worth?", Oxford Review of Economic Policy, 2019.
[135] G. R. Krippner, 2005.

we pointed out, this approach also has its pitfalls, such as potential KPI manipulation and short-term focus, caused by the complexity of sustainable issues and the need for multiple benchmarks to fully reflect the multi-faceted nature of sustainability. Therefore, it is essential to develop a governance system that is able to meet the demands of competitive sustainability. But what form should this system take?

The process of board level realignment begins with how Boards of Directors (BoDs) think about the company’s strategy and how it makes capital allocation decisions. In order to succeed in the marketplace in a competitive sustainability context, we argue that sustainability must be formally incorporated into the BoD’s core mandate and that more than the establishment of a dedicated ESG committee is required. Today, the vast majority of Boards treat sustainability as an ancillary “issue” on their Board agendas and not as an integrated aspect of the company’s competitive position[136]. In order to achieve competitive sustainability, Boards will need to rethink their approach and participate in a more holistic and integrated discussion of sustainability as part of their overall corporate strategic deliberations.

Executive incentives will have to move on from KPIs. While metrics are necessary, they should no longer be centred on short-term performance visibility. Rather, they should be oriented towards long-term value creation and be designed accordingly: with longer term horizons, for example, or using balanced scorecards that combine quantitative and qualitative criteria, or by ensuring that the key sustainability objectives are linked to the critical performance milestones in the context of a strategic transformation. Metrics should be a means to an end, not an end in themselves[137]. Any attempt to shift the focus away from governance will have to take into account the consequences. Those who seek to bring about the fundamental changes required for sustainable development will have to account for any costs, asset divestments or product portfolio adjustments. Board members and CEOs will have to be able to provide investors and other stakeholders with a justification for any trade-offs they make. Sustainability is a highly long-term-oriented concept, and the management of companies should be aware that they may not always be able to present short-term improvements in the performance of their shares. In order to provide a reliable counterbalance to any short-term market pressure and to ensure that the expectations of stakeholders are adapted to the time horizons associated with the necessary changes, companies must authentically report on their long-term goals[138].

The ownership structure of a company is an important factor. Companies with long-term institutional investors, family ownership or mission-driven investors often have more opportunities to act sustainably and invest in the long-term competitive renewal of their business. Shareholders such as activist investors or short-term institutional investors can hinder the corporate governance reform process. Thus, the topic of competitive sustainability is closely interlinked with issues of corporate governance and shareholder structure[139].

The governance and incentives realignment initiative is part of the larger effort to recapture strategic agency for the firm. Rather than being dictated to by external ESG rating agencies and frameworks, our research argues that successful firms will design governance structures and processes that tailor

[136] L. A. Bebchuk, R. Tallarita, 2020.
[137] A. Edmans, 2022.
[138] C. Mayer, 2019.
[139] A. Edmans, 2022; G. A. Epstein, 2005.

and interpret sustainability in ways that are most appropriate to their particular circumstances: taking into account their unique competitive advantages and capital structure. While ESG standards will still be relevant, they should be seen as only part of a more fully developed strategic framework, one that does not compromise the firm's ability to exercise its strategic discretion[140].

Transforming the governance system is a crucial step on the road to competitive sustainability. In the economic system we are used to, the governance system has to be reformed so that it is compatible with a competitive strategy based on sustainability. This reform can contribute significantly to eliminating the diseconomies of a system in which management focuses exclusively on meeting market demands, while being subject to the discipline of an imposing system of rules and laws. In this way, management will still have to be accountable to stakeholders, shareholders, employees, customers and local communities, for its actions. In this way, competitive sustainability will be able to transform governance from an enforcement instrument to an integrative instrument.,The evolution of sustainability cannot occur in isolation from the rest of the company's strategy. This evolution takes place in the context of the competitive situation of the industry, which is determined by a wide range of factors and is specific to each industry: technology, level of regulation, capital intensity, consumer preferences, etc. Competitive sustainability can only be dealt with by means of frameworks that take into account the diversity of possible strategic options for each industry[141].

The coming era of sustainability will demand a fundamentally different type of capital stock in order to ensure the success of the transition in production sectors characterized by transition pressure on core production technology. Transition pressure is defined as the magnitude of the required changes to the core production technology in a production sector. Energy, heavy materials, transport and parts of the chemical industry are examples of transition pressure being high. In order for the transition pressure to be decreased, core production technology in transition pressure intensive industries will have to be changed so that it is compatible with a future that is low on carbon. Competitive sustainability in these sectors will generally involve the use of resource intensive low-carbon technologies, process improvements and adaptation to new low-carbon value chains over the long term. There is a close relationship between sustainability and the industrial transformation of production sectors with high transition pressure. Many companies in these sectors will in the future have to base their competitive position on technological leadership as well as an ability to read the future of markets and policy developments[142]. As reputation is at stake and customer segments are often differentiated, organisations may use sustainability as a reputational tool or an innovation driver. Ethical sourcing, product traceability, design for reverseability, and transparency are increasingly becoming key factors in customer loyalty and brand image. In such contexts, competitive sustainability becomes a communication battle about narrative consistency and brand image integration[143].

The environmental impact of knowledge-intensive and digital economy activities is still limited. However, companies will have to address their sustainability strategy through other means, namely governance, data protection, diversity and social responsibility, as well as responsible innovation. The

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[140] J. Barney, 1991; M. E. Porter, 1985.
[141] M. E. Porter, 1985.
[142] M. E. Porter, C. van der Linde, 1995; S. L. Hart, 1995.
[143] J. Surroca et al., 2010; R. E. Freeman, 1984.

factors of competition in knowledge economy will also change and will come to depend more on culture, trust and anticipation of regulatory requirements. In this context, sustainability must be built into governance and innovation practices, without requiring the modification of physical assets[144].

Different variations of competitive sustainability imply that the concept is context-dependent. The driving forces behind the competitive sustainability advantage can be different in each industry and uniform benchmarking may mask these differences. While cross-sector benchmarking is unavoidable when measuring performance against uniform standards, companies must be able to interpret benchmarks differently in each industry in order to make sustainability a strategic concept[145]. Companies must also translate general sustainability requirements into more detailed and industry-specific competency development initiatives, rather than following a compliance-based approach and attempting to fit a square peg into a round hole. This strategy also deals with the risk of strategic homogenization that we mentioned earlier. By assigning a local context of sustainability to each firm in an industry, competitive sustainability allows each firm to be distinct while nonetheless being subject to the same regulatory framework and disclosure requirements. Competitive sustainability therefore reconciles the need for regulation and disclosure to be uniform at the level of external governance, while at the same time allowing each firm to have a context that is suited to its specific competitive situation.

For this interpretation of the relation between industry heterogeneity and the dynamics of competitive sustainability to be valid, the heterogeneity of an industry has to be possible to see as a context factor together with other structural elements within the framework, an assumption which is based on that sustainability as a strategic concept is a focus condition upon the specific structures of the competitive environment of a firm. Competitive sustainability is not a universal tool but a strategic approach which is defined by the industry context, resource structure and long term strategy.

5.3 The Normative Implications of Competitive Susta inability

Until now, we have explored the implications of ESG for corporate governance, investments and firm strategy. Our research explains how the financialized version of ESG shapes and transforms the market-based institutions that influence firms' behavior. ESG, we found, brings sustainability under the market governance regime that governs economic activities, but with a particular set of market distortions linked to the processes of metricization, speed and homogenization. Competitive sustainability represents one possible trajectory of this market-based governance of sustainability. It integrates sustainability into the firm-specific resources and long-term strategy[146].

From the theoretical to the normative From the preceding analysis it is clear that the issue of ESG and business strategy cannot be approached solely in theoretical terms. Our research question, as we have seen, has a theoretical component (what is the effect of ESG on business strategy) and a practical

[144] D. J. Teece, 2007.
[145] J. Barney, 1991.
[146] J. Barney, 1991; D. J. Teece, 2007.

one (how should a company react to the pressures arising from ESG). Thus, the chapter will start with a brief normative examination of the former in order to lay the groundwork for the examination of the latter. The central normative argument of this chapter is that the pursuit of sustainable competitiveness that is aligned with the principles of ESG should not be confined to the requirements of the ESG metrics and standards and to the ratings of the third party providers of such ratings. While adhering to the relevant ESG standards and regulations may often be necessary in order to achieve social legitimacy and access the capital markets, it is not sufficient to accomplish the goal of a company being a responsible business leader[147].

Sustainability should be considered as a competitive design parameter rather than as an exogenous constraint assessed by third parties. This implies a change in the managerial paradigm from being a reactive calculation of the responses to the ESG expectations of stakeholders to the proactive development of firm capabilities and to the coherence of long-term investments[148]. In short, companies should stop asking themselves how they will be able to comply with the ESG expectations of stakeholders and should start asking themselves how they will take sustainability into account in the company's future evolution. This is not a moral criticism of ESG reporting standards. ESG reporting standards are meant to increase transparency, comparability and accountability in capital markets. The normative claim is that participation in capital markets should be more responsible, not that companies have to report on ESG in order to be responsible. Rather, ESG reporting standards should be seen as a condition of participation in capital markets, a condition of participation rather than an end in itself. The companies' moral and economic responsibility is to make a sustainable contribution to society.

The normative challenge is not so much whether firms should engage with ESG issues (as they arguably should) but whether they should let external ESG metrics define the parameters of their own internal sustainability development efforts. Competitive sustainability posits that firms should have strategic discretion in relation to their own internal sustainability development and that their sustainability strategy should not be defined by a set of external ESG metrics that are relative to particular industry structures, firm capabilities and societal values[149].

The leadership responsibility for sustainability has to change to make competitive sustainability more than just a labeling exercise to ESG. Boards and chief executives are the leaders of companies that are subject to the pressures of ESG, applied by shareholders, enforced by laws and regulations and benchmarked by third party sustainability ratings[150]. However they retain discretion as to how they react to these pressures. Our research sets out a normative argument in respect of this choice. Boards and CEOs have a leadership responsibility to make sure that their company does not treat sustainability as no more than an accounting and compliance issue, but should instead make it a central factor when designing the firm's overall business strategy. Companies must practice capital allocation discipline. Purpose, sustainability commitments and long-term goals must be fully integrated into capital allocation decisions and flow through into specific investments, divestitures, R&D expenditures and other capital programs. Words, and associated media announcements, mean

[147] Regulation (EU) 2020/852; Regulation (EU) 2019/2088; E. Pollman, 2022.
[148] M. E. Porter, M. R. Kramer, 2011.
[149] G. A. Epstein, 2005; R. Shamir, 2008.
[150] L. A. Bebchuk, R. Tallarita, 2020.

nothing without real-world action[151]. For boards, no competitive advantage should be ceded to those who do not match their words with deeds, and for those with a sustainability narrative, the corresponding irreversible actions and capital expenditures must be delivered.

Most commentators accept that leadership has a role to play in the design of incentives. For example, the company might expect that ESG-linked pay will help to reinforce the expectations of ESG performance set out in its Sustainability Report. However, ESG-linked pay can include the same pitfalls as traditional KPIs which concentrate management's minds on short-term, quantitative, goals rather than longer-term, qualitative transformational outcomes. Look-back periods can be longer, performance measurement should be more balanced and the company may want to ensure that the incentives for workforce development are clear and that the potential distortionary effects of setting ESG targets are considered. Ultimately, the design of incentives is a values-based decision. And it is just one aspect of the competition for leadership in sustainability. Companies also need to take a different approach to their engagement with investors. Rather than seeing engagement as a purely defensive activity to prevent a downgrade in ESG ratings, companies need to think about how they can help investors to understand their long-term strategy and business model and therefore how they should be positioning their expectations for the future. To this end companies should make investors aware of the trade-offs they are making, the transition costs they are incurring and the investment they are making in research and development and innovation in order to ensure that expectations are set at a timescale that is commensurate with the company's own transition horizon[152]. And rather than simply bowing to pressure from investors, as a constraint that is unavoidable, companies should try to shape how that pressure is felt by communicating in different ways and by telling a different story.

The underlying principle of this writing is straightforward yet profound in impact. ESG issues should be viewed by boards as a regulatory floor that companies must comply with and strategies build upon. Metrics and benchmarks can be useful tools to set limits and to guide behaviour. However, always bringing in discretion and the exercise of judgement is crucial[153]. The role of Boards in relation to creating successful sustainable businesses has two facets: ensuring that companies comply with minimum standards of ESG behaviour and ensuring that companies are positioned for growth and innovation in a world where compliance with these standards is likely to be permanent. Global competition has given rise to what is now called competitive sustainability: a term that changes the rules of leadership. Competitive sustainability is a strategic concept that amounts to a new kind of leadership or stewardship. No longer is it simply an adaptive response to changing conditions in a highly competitive market, but rather a proactive strategic approach to leadership. Indeed, in a world where the economic governance system is based increasingly on market mechanisms, safeguarding the long-term strategic capacity of a firm is a way of fulfilling a responsibility. Thus, companies that are able to reconcile the challenges of the market with those of sustainable development are not only economically efficient, but they are also in a position to act as agents in the pursuit of systemic and enduring forms of sustainable development that can really bring about societal transformation.

This paper continues the discussion on competitive sustainability and the future of corporate governance and sustainable capitalism. The Financialization of ESG explores the opportunities and

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[151] C. Mayer, 2019.
[152] A. Edmans, 2022.
[153] F. Berg et al., 2022.

challenges associated with integrating environmental and social issues into the market provided that they can be translated into quantifiable risk metrics. The market-based integration of sustainability per se is not sufficient to address the systemic issues associated with the transition to the new sustainable economy. Thus, the future of governance will depend on a more balanced interaction between market forces and managerial authority.As we look ahead, I believe that corporate governance will have to deal with at least three types of challenges in the years to come: regulatory, shareholder and transformational. Boards of directors will have to both control the ESG performance of their companies and ensure that the principles of sustainability they endorse are translated into the company's capital structure. They will have to take into account, when making their decisions, the opportunities and risks presented by new technologies, climate scenario analysis and the monitoring of systemic risks. The creation of a dedicated Sustainability committee is obviously an excellent idea, but it must also be closely linked to the control function that oversees the company's financial and operational performance.

The corporate strategy of the firm and the firm–investor relationship will also have to be adapted. It is conceivable that shareholders will increasingly be demanding transition roadmaps from companies. The shares of companies operating in highly different long-term growth prospects are included in widely used market indices. Capital markets can therefore become a barrier rather than an engine for change, depending on whether companies provide transition strategies and shareholders accept the necessary short-term drops in value during the transition period. Competitive sustainability will therefore also have to be achieved in more cooperative forms of market governance. Sustainability competition is a phenomenon that demands a new paradigm of sustainable capitalism far removed from the current accounting practice of ensuring transparency and comparability through disclosure based on conventional accounting standards. While disclosure and comparability are important building blocks of a sustainable economy, the sustainability of the transition to competitive sustainability will depend on the ability of firms to innovate strategically in their industries. Markets can impose discipline on firms but firms must innovate in order to assure the future of capitalism. The sustainability of capitalism will depend on whether firms incorporate sustainability as an internal risk-reduction measure or as a competitive renewal principle.

Thus competitive sustainability is not a departure from the market economy, but a new stage in its evolution, a more mature stage, by incorporating sustainability and competitiveness. There is no contradiction between the two as long as sustainability is a factor in the company's strategy and not a set of goals to be achieved through management of indicators. In this way, the new stage of corporate governance will be measured not only by the quality of ESG disclosure, but also by the impact of sustainability on the company's investment projects, capacity-building and structural adjustment of the market.

This thesis analyses the transformation of the concept of corporate responsibility from CSR to ESG and how sustainability has been taylor-made and market-made in contemporary capitalism. The main purpose is to investigate if ESG is a paradigmatic innovation of the concept of corporate responsibility, by embedding a new responsibility rationale that is no longer normative, but risk pricing, share price-oriented and governance regulated.

The study analyses the different practices of financialized ESG and identifies both progress and obstacles in the context of contemporary sustainability governance. While financialized ESG is thought to promote the integration of sustainable development concerns into market-based economic processes, making them more visible and relevant for companies and other stakeholders, it also harbours several critical tendencies that need to be examined more closely. The use of indices, benchmarking and market prices to measure ESG standards can lead to standardisation of company practices, focus on short-term interests and merely managerial forms of organisational adaptation. The ambivalence of current sustainability governance is therefore not incidental, but instead an inherent part of the ways in which different forms of financialised ESG are used. One of the major challenges for firms today is to cope with the increasing pressure stemming from the growing conflict between external competitive and accountability-based and internal competitive and differentiating pressures. Competitive sustainability is proposed as an evolutionary answer to this challenge. Competitive sustainability is defined as the process of integrating sustainability into firms' capability architecture, long term capital budgeting, governance and industry specific strategy; and of transforming the constraint imposed by evaluative criteria into a competitive design dimension.

It is not that we think that ESG should be abolished, but rather that it needs to be transcended in the overall strategy of a company. ESG should be included in the rules and minimum standards that companies follow but should not be allowed to interfere with the strategic freedom of the company in relation to the choice of business strategy and the type of stakeholder engagement that takes place beyond the standard of minimum ESG compliance. The future of sustainable business will be determined by more than just better and more refined ESG metrics – it will be determined by whether companies are able to transform environmental and social considerations into the very foundation of the competitive firm.

Today we talk about CSR, then about ESG and finally about competitive sustainability. Where in the first case we dealt with a PR issue, in the second with the inclusion of social and environmental issues in the governance and reporting structure of the company, and in the third case with the competitiveness that derives from sustainability. We moved from philanthropic dollars, which correspond to the traditional charitable act that can be represented by the simple act of giving money to someone in need, to measurements such as: liters of water per barrel of oil, tons of CO2 per barrel of oil, or even fish taken as bycatch from the barrels of oil extracted. Which means that measuring sustainability is not at all equivalent to practicing good stewardship. Companies have a long way to go before their sustainability practices are competitively viable and before the practices of stewardship are fully incorporated into a company's competitive strategy. 21st-century leaders have a lot of work to do. Leadership in the 21st century will not be about compliance with stakeholder expectations or about meeting socially responsible or environmentally sustainable needs.

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