# FINANCIAL REGULATION

## The Impacts of Mandatory ESG Disclosure on Financial Performance

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## Abstract

Since the appointment of Donald Trump as the 47th president of the United States, we saw the Federal Reserve pivot away from Environmental, Social, Governance (ESG) regulation by discontinuing its involvement in the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) (Segal, 2025). Across the pond, European Central Banks have continued to retain their "green" focus, with the Bank of England viewing climate-related risks as an integral part of financial stability (Stimson, 2024). Nonetheless, with its increasing popularity – even across the portfolio construction of investors – ESG has become a source of controversy. Our paper therefore examines the impact that ESG disclosure frameworks and practices have had on several financial indicators across the UK and other regions to determine whether these regulations have had a positive financial impact on banks, investors, as well as the wider economy. We do this by conducting a review of the outstanding literature and argue the need for several legal and policy adjustments including the standardisation of ESG reporting frameworks, the formal integration of ESG metrics into financial risk assessments, as well as enhanced transparency and accountability in ESG ratings.

## About Leeds Policy Institute

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## Policy Recommendations:

1. **Standardisation of ESG Reporting Frameworks:** To mitigate inconsistencies across ESG disclosures, we recommend the adoption of standardised frameworks. This includes harmonising reporting requirements under the UK Corporate Governance Code and the 2020 Stewardship Code, alongside alignment with international benchmarks like the EU's Sustainable Finance Disclosure Regulation (SFDR). Standardisation will enhance comparability, reduce reporting ambiguities, and improve investor confidence.

2. **Enhanced Transparency and Accountability in ESG Ratings:** To address concerns regarding opaque ESG ratings, we propose mandatory disclosure of rating methodologies and weightings used by rating agencies. Banks should be required to publish detailed ESG performance reports, including metrics on environmental impact, social responsibility, and governance structures. This approach ensures greater accountability and facilitates informed decision-making by stakeholders.

3. **Integration of ESG Metrics into Financial Risk Assessments:** Financial institutions should incorporate ESG factors into their risk assessment models. This involves embedding ESG-related risks—such as climate change impacts or governance failures—into credit ratings and investment appraisals. Doing so will align ESG performance with traditional financial metrics, highlighting the long-term benefits of sustainable practices.

4. **Fostering International Collaboration on ESG Standards:** Given the global nature of financial markets, we advocate for enhanced international cooperation to harmonise ESG standards. Cross-border initiatives can facilitate knowledge exchange, promote best practices, and create a level playing field for companies operating in multiple jurisdictions.

5. **Continuous Evaluation and Adaptation of ESG Policies:** ESG-related policies should undergo regular reviews to assess their effectiveness and relevance. Feedback mechanisms, data-driven evaluations, and adaptive policy-making will ensure that ESG regulations evolve in response to emerging sustainability challenges and market dynamics.

# 1 Introduction

## 1.1 Origins of Environmental Social Governance (ESG)

The term 'ESG' (Environmental, Social, Governance) is refers to a broader assessment of an organisation's sustainability within its ecosystem. The environmental aspect relates to the impact of emissions and resource use, the social element addresses protection of communities from negative externalities, and governance focuses on corporate transparency (Conway, 2023). ESG regulation can impact several indicators that measure a bank's financial performance such as Return on Equity (ROE) – which measures a bank's ability to generate profits for shareholders (Mardiyanto, 2009 cited in Ichsani and Suhardi, 2015) – as well as Stock Returns, which reflect how much capital a firm generates by analysing stock price changes, including dividends (Schweitzer, 1989). We use these indicators to evaluate whether ESG disclosure regulations have had a positive financial impact on banks, or if investor interest has waned due to stricter environmental compliance. We believe that our paper comes at an important time both because of political developments and largely because investors are becoming more selective in portfolio construction, often taking into account environmental and social factors. ESG ratings can indicate a bank's transparency and quality of governance (Diaz et al., 2021).

Our paper males use of key UK ESG disclosure frameworks, including the 2018 Corporate Governance Code and the 2020 Stewardship Code as banks often struggle to balance regulatory compliance costs with potential long-term financial benefits. Maintaining these frameworks can be difficult and sometimes leads to community bank failures, prompting government intervention and discouraging risk-averse investors (Slaney, 2021). Globally, many countries are implementing ESG regulations, not just in financial institutions but as part of broader sustainability goals.

We can see this trend most notably in the UN Sustainable Development Goals (SDGs) which aim to integrate social development, environmental sustainability, and economic growth (Park and Jang, 2021). We therefore explore how efforts to enhance environmental sustainability can hinder economic growth, especially when wealthy investors choose between clean funds and more profitable portfolios in less regulated nations. Ultimately, we investigate how policy mechanisms—particularly those that incentivise ESG compliance—can promote financial gains for banks while offering both short-term and long-term downside protection.

## 1.2 Background and Context

ESG has gained prominence recently due to climate change fears, geopolitical crises, and pandemics (United Nations, 2023). The focus on ESG underscores shortcomings in governments' ability to address social problems. So, the narrative has shifted in the direction of the private sector specifically for solutions to "E" and "S" problems (Macey 2022). Although ESG's visibility has skyrocketed in recent years, its origination can be charted back to 2004 with the United Nations Global Compact [UNGC]. The ten principles, centred around human rights, labour, environment, and anti-corruption, acted as a guideline for a company's corporate sustainability responsibility [CSR] (UNGC, 2004). However, the term ESG was first used in 2004, in the UNGC's, "Who Cares Wins" report. The report saw collaboration between the UN and twenty financial institutions to develop instruction on how to integrate ESG into their business strategy and in doing so maximize their shareholder value (UNGC 2004) with the aim being to galvanize collective action resulting in stronger investment markets, and to enhance the sustainable development of societies (UNGC 2004).

ESG critics suggest the acronym encompasses too much, resulting in variation in application, which leads to confusion. The breadth means it is difficult to highlight a causal relationship between ESG and financial performance [empirically]' (Pollman 2022) with critics also arguing that ESG can open the door for "sustainability arbitrage" to be committed as there are countless trade-offs between the components with carbon emissions opposing workers' interests for instance (Pollman 2022). There are also concerns over reporting practices. Over 1,000 cases concerning environmental change have been reported globally since 2015 (Garg and Cheema 2022). However, since 2022, a trend of new ESG-related laws across the world has emerged to crack down on discrepancies. The European Union [EU] has been particularly stringent with its imposition of the Sustainable Financial Disclosure Regulation [SFDR] (Garg and Cheema 2022).

## 1.3 Theories

The validity of ESG disclosure has been debated through various theories. Pro-ESG disclosure theories stress the value of transparency and improving company credibility in increasing customer and shareholder faith (Tripopskul & Puriwat, 2022); anti-ESG disclosure theories argue that money put towards ESG development and disclosure can be spent in more money-maximizing plans which would already be done by a profits driven market (Jacobs, 2024). Legitimacy theory (Nazarova et al., 2023) explores how the activities of a company can directly impact the public's perception of it (Nazarova et al., 2023). It believes that legitimacy depends on how much the actions of a company align with society's expectations of it (Mahmud, 2020). With the rising interest in sustainability, Legitimacy theory argues that when companies share their ESG-related information, they align themselves more with societal values, thereby increasing consumer trust and company approval (Nazarova et al., 2023).

This is substantiated by the stakeholder theory by Freeman in 1993, which says that every individual stakeholder of the firm should be considered while implementing business decisions (Nazarova et al., 2023). This theory supports ESG disclosure as it is seen as the firm's ethical responsibility to erase any information asymmetry (Mahmud, 2020). Disclosure is also used as a strategic move to improve their relationship with important stakeholders through long-term relationship creation and promotion of transparency and legitimacy (Mahmud, 2020). However, some scholars argue that a firm's only responsibility is to maximise profit, with all firm decisions made to increase value generation for important shareholders (Nazarova et al., 2023). Therefore, spending on ESG disclosure is critiqued because of the negative impact on profitable income.

# 2 Literature Review

## 2.1 Overview

This section examines a selected group of publicly listed companies and traditional banks that have been subject to recent ESG disclosure requirements. We review studies that include institutions operating in mature financial markets—such as those governed by the UK Corporate Governance Code, 2020 Stewardship Code and the EU's Sustainable Finance Disclosure Regulation (SFDR) — as well as those in regions with less established ESG frameworks. The firms across these studies were chosen based on their size, market influence, availability of robust financial and ESG data, and their varying degrees of regulatory engagement, ensuring a balanced perspective across different jurisdictions and reporting environments.

In evaluating the impact of mandatory ESG disclosures, several financial performance indicators were considered. Profitability metrics such as Return on Equity (ROE), Return on Assets (ROA), and Net Interest Margins gauge how effectively firms convert their resources into earnings, while market-based indicators—like stock returns, share price volatility, and valuation multiples—capture investor sentiment and market confidence.

Preliminary observations suggest a heterogeneous relationship. Some European banks, operating under relatively mature ESG disclosure regimes, appear to have enhanced their profitability and share price resilience, potentially due to improved investor trust, better stakeholder engagement, and proactive sustainability measures (Buallay et al., 2021). In contrast, certain institutions in regions where ESG reporting is either nascent or less enforced may find that compliance costs and operational adjustments do not immediately translate into financial gains (El Khoury, 2021). However, there also are some studies that indicate that the direct impact of ESG and its pillars varies across different contexts (Buallay, 2018; Martiny et al, 2024). Both external and internal factors, including risk-taking, could influence the relationship between ESG and financial performance, either by acting as mediators or moderators, highlighting the need for further investigation into these dynamics.

## 2.2 Case Studies

Sustainability indices are created as benchmarks for sustainable investments, a large term that encompasses a range of concepts. (Vives et, al 2012) Whelan et, al (2021) found that a firm's financial performance improves over a long horizon due to ESG. The researchers also found that ESG investing provides downside protection, especially during times of crisis, such as economic or social crisis. Fernandez et, al (2019) find that during the financial crisis, German Green Mutual Funds provided slightly better risk-adjusted returns than competitors.

Fatemi et, al (n.d) concluded that ESG strengths increase firm value while ESG concerns reduce it. They also find that governance concerns lead to much steeper discounts than environmental or sustainability concerns which could be attributed to there being a difference in opacity. Governance-related disclosures are usually mandated by the Government, where investors can check their veracity with ease due to these being public records (Lipton, 2019). Environmental and Sustainability disclosures, on the other hand, are harder to verify due to them being voluntary, and therefore opaquer. In almost all the studies within our literature review, we have seen a sharp increase in investing profits of green funds as compared to normal funds.

Both the UK and wider international case studies highlight ESG disclosure requirement's impact on financial performance. Evidence from the EU and the US shows regulatory efforts to increase transparency in firm activity to be effective at improving disclosure commitment and effectiveness (Cicchiello et al, 2022). Building on this, there is evidence in the Growth Enterprise Market (GEM) in China that green innovation improves ESG scores, which in turn improves the financial performance of these firms (Zheng et al, 2022). The authors recommend mandatory pollutant disclosures of GEM-listed firms, supporting calls for tighter ESG disclosure requirements in the UK. While empirical evidence from the Italian stock market between 2007-15 reveals that market premiums are not significantly impacted by socially responsible investment, paper authors comment that it will play a role in the future (Landi & Sciarelli, 2019). Despite this, Italy experienced growth in the popularity of socially responsible investment during this period, alongside increasing managerial interest in corporate social responsibility. While explicit evidence in Italy appears to oppose ESG disclosure requirements, underlying trends in socially responsible investments support its implementation.

# 3 Concluding Remarks and Policy Recommendations

## 3.1 Conclusion

Our review into the literature of mandatory ESG disclosure regulations on the financial performance, considering factors such as profitability or stock returns, of publicly listed companies and traditional banks exhibits how recent and underdeveloped ESG regulations are. It is only within the last 10 years that this topic matter has become more prevalent in the discussions that occur at some of the world's largest investment banks. We have investigated into why ESG is such a hot topic in 2024, despite some of the potential confusion that exists of how banks could successfully incorporate these cumbersome policies into investor decisions. When analysing banks' previous experiences with incorporating ESG and taking on board policy recommendations, key theories must be considered, such as Legitimacy Theory to eliminate asymmetric information. While some both national and global banks have benefited from these very effective regulatory frameworks, such as in the majority Of Europe, others have reported a decline in the number of investors. Nevertheless, nations with thriving economies, such as China, have responded well to these transformations, targeting the nations ongoing air pollution crisis through eliminating it at the root of secondary industries. Therefore, there must consistency with the policies recommended, most importantly transparency in the release of ESG ratings. To finish, we stress the importance of there being an accurate approach to implementing these laws without ignoring any information failures, so that widespread climate change and social injustice can be diminished.

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