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Peer Effects of Commitment to ESG Goals – How Stakeholders Affect One Another in the Ecosystem

Companies today are becoming more socially responsible and have begun to integrate corporate social responsibility (CSR) into their business models. CSR refers to a firm's commitment to pursue business objectives that lead to positive social and environmental outcomes rather than focusing solely on maximizing economic goals. It has become increasingly important for companies to commit to CSR goals to ensure that their business remains ethical and sustainable in the long term. Research has shown that CSR has been able to reduce risk and increase customer satisfaction and market value. CSR strategies carried out by stakeholders in an ecosystem can have a significant and material impact on peer firms. Peer firms are pressured to commit to higher CSR standards set by their clients, suppliers or competitors. This article reviews three major channels through which peer effects of corporate commitment to ESG goals, as documented in the academic literature (some of which are written by the author of this article), can take place: product market competition, global supply chain, and institutional investors' propagation.

PEER EFFECTS ON COMPETITORS: CSR STRATEGIES WILL HAVE A MATERIAL IMPACT ON THE STOCK PRICE OF COMPETITORS

CSR policies have become widely adopted by companies across the world. In the United States, the Governance & Accountability Institute (G&A) found that the number of S&P500 companies that release sustainability reports reached an all-time high of 90 percent in 2020, compared to a figure of only 20 percent in 2011. Despite the widespread publishing of CSR reports, there are still doubts as to whether this increase is due to investors and companies reacting to peers' CSR strategies or whether there are other factors at play which influence the company's decision to adopt CSR initiatives.

The underlying argument is that companies do not operate in silos. Their actions are often observed and replicated by peers. If CSR can indeed increase firm value, a company's adoption of CSR will put it at a competitive advantage and its competitors at a competitive disadvantage. When a company introduces CSR strategies, peers may see it as a threat and respond strategically by adopting new CSR initiatives so as not to be left behind. An example is a firm which invested in an environmentally friendly technology that is able to reduce carbon emission in its production processes. By utilizing an environmentally friendly technology, a firm is able to humanize its brand and develop brand empathy with socially conscious consumers. Yet, despite the numerous advantages of doing so, companies may not want to shift to an environmentally friendly technology, as this can potentially lead to margins being eroded from their bottom line. However, when one company decides to challenge the status quo and invest in the technology, it will be able to gain a competitive advantage over its peers. As a result, peers who believe that they will lose their edge may invest in this environmentally friendly technology to ensure that it remains competitive in the industry.

Empirical Evidence

The authors of a paper titled "Peer Effects of Corporate Social Responsibility" (Cao, Liang, and Zhan 2019) investigated how listed companies responded to competitors' adoption of CSR-related shareholder proposals that are being voted during shareholder meetings. The study tested more than 3,000 US public nonvoting peer firms in the period between 1997 and 2011. They compared the effects of a firm's shareholder-sponsored CSR proposals at annual meetings that either pass or fail by a small margin (around the 50 percent threshold) with the product-market peer firms' response in terms of ESG commitment. This is to reproduce a randomized assignment of CSR proposals to companies and, hence, ensure that it is not correlated

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with peer-firm characteristics. The underlying idea is that there is no reason to expect that a peer firm of a company that marginally passes a CSR proposal is systematically different from a company in which a CSR proposal marginally fails. Hence, these 'close-call' CSR proposals provide a good proxy of a random variation of a firm's commitment to ESG that can be used to estimate causal ESG peer effects.

The authors observed two key results. (1) The passage of a close-call CSR proposal by a firm led to the adoption of a similar CSR practice by its competitors the following year, as measured by their corresponding CSR scores. (2) Firms that passed a close-call CSR proposal were able to achieve a higher three-day cumulative abnormal return (CAR) and subsequently a higher CSR score, whereas its competitors experienced a lower CAR around the same dates. This indicates that firms that were unable to catch up with peers that pass a close-call CSR proposal suffered a significantly lower stock return, which is consistent with the notion that CSR is a strategic move in response to a threat by other firms. Given the possibility that some of the proposals were not implemented, the authors conducted a textual analysis to disentangle the effect of passage and actual implementation. They found that the effects were even stronger if the close-call CSR proposal was implemented in the following year (based on news reports), which suggests that the effects were not simply a signal but could in fact have a material impact on peer firms.

PEER EFFECTS ON SUPPLIERS: CUSTOMERS ARE ABLE TO EXERT CONSIDERABLE INFLUENCE ON THE CSR STANDARDS OF THEIR SUPPLIERS

Another mechanism through which ESG commitments can spill over among peers is the supply chain. Anecdotal evidence has suggested that as corporations develop their CSR policies, corporate customers become increasingly concerned not just with their own CSR standards, but also those of their suppliers. As more companies shift their supply chain overseas to gain a competitive advantage, corporations finding it challenging to enforce their CSR standards are on their supplier networks. Despite the high cost of ensuring that their global supply chain meets the CSR standards, there are several reasons why corporations are driven to do this. Motivations for pushing suppliers to employ CSR strategies include appeasing stakeholders, avoiding negative publicity, retaining employees and attracting new customers who are interested in purchasing products from firms that themselves purchase from sustainable sources.

Empirical Evidence

Using the Factset Revere database of firm-level networks of customers and suppliers around the world and Thomson Reuters's ASSET4 database of firm-level ESG ratings, the authors of a recent study titled "Socially Responsible Corporate Customers" (Dai, Liang, and Ng 2020) obtained a sample comprising 34,117 unique corporate customer-supplier pairs from 50 countries worldwide for the period 2003 to 2015. They found evidence that customers made an effort to ensure that suppliers met certain CSR standards while not exhibiting any influence on customers' CSR standards.

However, a potential issue is that even though there are strong correlations between customer CSR and subsequent improvements in suppliers' CSR practices, it may be because customers tend to select suppliers that are more likely to cooperate and commit to high CSR standards. To circumvent this issue, the authors examined the effect of customers on suppliers' CSR standards by employing a regression discontinuity approach that relies similarly on the passage of close-call proposals. The results suggest that the passage of a customer's close-call CSR proposal will indeed lead to their suppliers adopting similar CSR initiatives, as evidenced by the increase in the supplier's CSR score in the following year, as compared to a supplier for whom the customer's CSR proposal fails by a small margin. In another test, the authors looked at companies that were affected by unexpected product safety scandals, such as the 2008 Chinese milk scandal and the 2013 Toyota car/Takata airbag recalls. The results showed a positive correlation between a customer's product responsibility rating and that of its supplier, which became even stronger for firms in the relevant industry and on the relevant markets, after the year of the scandal. This suggests that the improvement in CSR could be attributed to customers pushing their suppliers to improve their behavior in response to the scandal.

PEER EFFECTS OF INSTITUTIONAL OWNERSHIP: SHAREHOLDERS HAVE AN IMPORTANT ROLE TO PLAY IN DRIVING ESG CHANGE WITHIN A FIRM

Institutional investors play a huge role not only in the practice of responsible investing, but also in the propagation of ESG commitments among their portfolio companies through both engagement and voting by feet. There has been increasing pressure by capital owners on institutional investors to ensure that they consider ESG issues when deciding how to deploy their capital. Investors today assess companies not only on the potential financial gains to be had from their investments, but also on the environmental and social (E&S) outcome that can be achieved.

Empirical Evidence

Various studies have been conducted on responsible investing. The authors of a working paper ti-

tled "*Responsible Institutional Investing Around the World*" (Gibson, Glossner, Krueger, Matos, and Steffen 2020) used survey data from the UN Principles for Responsible Investment (UN PRI). UN PRI is the world's largest group of institutional investors that encourages signatories to engage in responsible investment to enhance returns and manage risks more effectively. The authors of another study, titled "*Do Institutional Investors Drive Corporate Social Responsibility?*" (Dyck, Lins, Roth, and Wagner 2019) obtained data from the Thomson Reuters ASSET4 database for firm-level ESG ratings and the FactSet database for firm-level institutional ownership. The samples comprise 19,849 firm-year observations and cover 3,277 firms from 41 countries in the period 2004–2013. Three interesting observations can be made in these two studies with regard to how institutional investors propagate ESG practices among its portfolio companies.

The first observation is that institutional investors tend to propagate better ESG practices by being signatories of the UN PRI. This is likely due to the signatories' desire to demonstrate their commitment to achieving the six 'Principles of Responsible Investment'. These include incorporating ESG issues into the investment analysis, engaging with firms to improve ESG practices, and seeking disclosures from portfolio companies on ESG-related issues. As such, it is likely that signatories will take greater responsibility and actively manage ESG issues in their portfolio. Research has shown that the ESG impact of institutional investors who are signatories of the UN PRI is greater than those who did not sign. However, UN PRI signatories exhibit different levels of ESG practice depending on the country in which they are based. UN PRI members in countries outside the United States exhibit better ESG footprints than investors based in the United States. It is even more surprising that signatories based in the United States tend to exhibit ESG footprints that are no better than those of non-signatories. Despite United States based investors forming the largest group of new PRI signatories in recent years, there are no evidence which show that they improve their ESG footprints after signing the PRI. It was also observed that if they only implement a partial ESG strategy (applying it only to a fraction of their total assets under management), these signatories exhibit even worse ESG footprints than their non-signatory counterparts. Furthermore, the authors found that United States-based investment managers mainly serve the retail segment rather than institutional clients who monitor their managers more closely. This suggests that some United States based signatories are engaging in 'greenwashing' to attract more capital from ESG-conscious investors.

The second observation is that institutional investors propagate better ESG practices by using selection criteria and a strong voice. The first mechanism is the threat of exit or of investing only in firms with strong E&S policies. The second is to use their shareholding voice to engage with the management. Institutional investors are able to utilize several methods to determine whether to invest or to exit an investment, which include using negative screening to exclude poor E&S-performing firms or positive screening to invest only in firms with certain E&S standards. However, this does not always lead to better returns. In the first study, the authors found evidence that certain selection methods such as negative screening, integration, and engagement reduces portfolio risk but does not enhance returns, and they concluded that ESG strategies mainly serve risk-management purposes. Furthermore, the institutional investors' voice is a powerful mechanism in pushing for E&S change. Having a dominant voice is important when being part of an investor organization such as the UN PRI, which advocates active engagement of its signatories with firms in order to enhance their E&S performance. More importantly, the authors found that successful proposals are typically not voted on and suggest that E&S shareholder proposals are primarily driven by private negotiations. The authors conclude that private engagement is the main channel through which investors push firms to enhance their E&S standards.

The third observation is that institutional investors propagate ESG practices by driving firms to lower risk. Institutional investors drive firms to improve their E&S performance so as to achieve better financial returns. Institutional investors that focus on E&S activism are concerned with managing long-term risk and aim at achieving a long-term return on their investment. E&S investment is able to provide insurance against event risk and product market differentiation. Furthermore, Evidence that investors are motivated by financial returns can be seen in the Deepwater Horizon crisis, in which the institutional investors' push for better E&S performance only impacted the environmental aspect and only for extractive industries. The goal of institutional investors in this case was to reduce the potential of another incident occurring in the future that would cause them to incur unexpected costs.

CONCLUSION

This article looks at the key channels through which peer effects of commitment to ESG goals can take place. The channels and impacts mentioned in this article are by no means exhaustive, but the benefits of commitment to ESG goals are immense. Commitment to ESG goals has been shown to create value, as it lowers risk and generates positive externalities to the environment. An important policy implication of these findings is that there is a ripple effect from improving one company's ESG commitment, as it will likely propagate to other companies through

product market competition, the global supply chain, and institutional shareholding. Such ESG spillover can trigger a multiplier effect. From a managerial perspective, it is important that a firm takes into account peer firms' ESG policies when designing its own strategy and CSR policy. However, despite the vast improvement in stakeholder commitment to ESG goals, there are still more measures that could be taken by firms to influence peers in improving their ESG footprints. These may include firms setting a high CSR standard as an industry benchmark, customers placing social pressures on their suppliers to commit to ESG goals, and investors directing their fund managers to implement a complete ESG strategy instead of engaging in 'greenwashing'.

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