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Financialization and ESG Investing: Implications for Real Investment and Economic Growth

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Abstract

This research study explores the Pakistani non-financial firms by analyzing the intricate relationship among the variables financialization, sustainability reporting and accumulation of real capital. By studying the impact of non-operating profits, financial payments, corporate governance attributes, buybacks and environmental factors on real capital accumulation, this research provides insightful investment strategies. Underscoring the pivotal role of financialization in shaping investment decisions, the results suggests that financial payments put a positive considerable influence on real capital accumulation. On the other hand, buyback have negative insignificant impact on real capital accumulation which suggests that stock buyback do not significantly contributes to the real capital investments, whereas non-operating profits showed positive but insignificant impact on the real capital investment. Attributes of corporate governance are also studied, where independent board members and board size demonstrated significant and positive impact on the real capital accumulation. These findings are inline with the theories of finance i.e., agency theory and stakeholders' theory, which emphasize the importance of larger boards and independent directors which help to promote the real capital investment. At the same time frequency of the meetings of board did not exhibit a significant positive impact on real capital accumulation. The study also examined the impact of environmental factors over the real capital accumulation in Pakistani firms, study of

which reveals that these factors do not have any significant impact on real capital accumulation which raised the concern of environmental sustainability. This study will contribute to the literature of corporate investment decision making using the variables of financialization and sustainability, this also provides valuable insights for managers, investors, and policymakers in understanding the impact of real capital accumulation and the need for effective corporate governance practices.
Keywords: Financialization, Sustainability Reporting, Accumulation of Real capital, Corporate Governance.

1. Introduction

Capital accumulation is the process of increasing wealth by investing income and savings. Financialization can have positive as well as negative effects on real investment. The increased investment in financial assets can have a "crowding out" effect on real investment, but financialization can also have a positive long-term effect on investment, as the capital generated from financial investment can be used to fund real investment in the future. ESG investments are becoming increasingly important in asset management due to government and regulatory pressures, investor demand, and the availability of more data. ESG scores are a great way to ensure that investments are made in companies with the best environmental, social, and governance practices. However, the lack of consistent measures for measuring ESG factors makes it difficult to compare companies and industries within a country. Asset managers demand sustainability evaluation for guidance and benchmarking (Searcy & Elkhawas, 2012).

ESG (Environmental, Social, and Governance) rating agencies assess environmental, corporate governance, and social policies on a company to determine its sustainability. The ESG score's veracity is questioned due to the various criteria utilized to calculate it: a lack of standards, information trustworthiness, openness, and independence imply bias and compromises. ESG scores are also supported by the DJSI or the MSCI ESG Indexes, which are used in the ESG investment process

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(Searcy & Elkhawas, 2012). Universities, social contribution trading funds, pension funds, and other institutional investors seeking long-term financial stability consider ESG ratings when making investment selections. An ESG rating firm is typically engaged by the company to do an in-depth review of its practices and then assist it in developing stronger policies. ESG rating providers are also becoming increasingly popular with companies seeking excellent reputation (and increased revenue) – something that may be accomplished through positive ESG developments and progress (Searcy & Elkhawas, 2012). ESG-related assets under management are mostly held in active strategies, with passive ESG strategies becoming increasingly popular (Dellery, 2009; Hachenberg & Schiereck, 2018). Green bonds are becoming more popular, but there is a lack of uniform measures for tracking ESG activities (Ferrell et al., 2019; Guiso et al., 2006). ESG scores are an essential tool for asset managers and investors for evaluating sustainability factors among companies (Edmans, 2011; Helliwell & Putnam, 1995).

Financialization is characterized by increased ratios of financial payment for interest, dividend payment and stock buybacks (Guiso et al., 2008; Hein & van Treeck, 2008). This can undermine real investment by putting pressure on non-financial corporations (NFCs) to raise the payments for dividends and stock buybacks on the financial markets (Orhangazi, 2008). The financial crisis of 2008 reaffirmed the public about the shortcomings of financialization and led to a renewed interest in sustainability reporting as a possible corporate governance model (Ferrell et al., 2019). The financial crisis also underlined the importance of confidence for well-functioning markets and financial stability (Helliwell & Putnam, 1995). Social capital is an organization's ability to develop trust and cooperation between stakeholders. According to Degli Antoni and Portale (2011), this can be valuable in a low trust environment, as investors will be more likely to charge a premium on firms with high social capital. Guiso et al. (2008) found that high-CSR companies also outperform low-CSR firms in non-crisis periods. Knack and Keefer

(1997) concluded that social capital has an economic payoff, as it can lead to higher economic growth. Edmans (2011) found that socially responsible investing does not sacrifice returns and can even lead to higher returns in some cases.

1.2 Problem Statement

The importance of sustainability reporting in the modern world is reinforced by the SDGs which were adopted by all UN Member States in 2015. Sustainability reporting can help corporations in finding the right balance between real capital investments and financial market investments. The application of technology in finance to ESG investments and Socially Responsible Investment (SRI)-related issues will significantly minimize financial risks. This study aims to fill the gap in research on the impact of sustainability reporting on the accumulation of real capital in the context of financialization by exploring the specific role played by economic, social contribution and governance components of sustainability reporting.

1.3 Research Question

This study will be conducted in order to find out answers to the following questions:

1. What is the impact of financial payments on accumulation of real capital in Pakistani non-financial firms or not?
2. What is the impact of non-operating profit on accumulation of real capital in Pakistani non-financial firms or not?
3. What is the impact of buybacks on accumulation of real capital in Pakistani non-financial firms or not?
4. Whether Environmental will have an impact on the accumulation of real capital in Pakistani non-financial firms or not?

1.4 Research objective

Research Objectives are:

1. To examine the impact of financial payments impact on accumulation of real capital in Pakistani non-financial firms.

2. To examine the impact of non-operating profit impact on accumulation of real capital in Pakistani non-financial firms.

3. To determine the impact of buybacks impact on accumulation of real capital in Pakistani non-financial firms.

4. To determine the impact of ENV impact on accumulation of real capital in Pakistani non-financial firms.

1.5 Significance

Sustainability reporting is an important tool for companies to manage their social and environmental impacts and enhance operational effectiveness. There is a growing trend of sustainability reporting, especially among large multinationals. The financial crisis of 2008-2009 has highlighted the importance of corporate social contribution capital, which can be seen as an insurance policy against economic downturns. This study investigates the relationship between financialization, accumulation of real capital, and sustainability reporting results in non-financial firms.

1.6 Literature Contribution

The present study investigates the impact of ARC (Accumulation of Real Capital) on financialization and sustainability reporting in the context of Pakistani market. This study is significant as it fills the gap in the literature by introducing ARC as a novel dependent variable and by highlighting agency theory as a base theory for the direct relationship between ARC and financialization and sustainability reporting. The results of the study are important for developing rules pertaining to BOD decisions in establishing capital markets such as Pakistan.

2. Literature Review

The term "financialization" has been used to describe the increasing role of finance in the economy since the late 1960s. This shift has been driven by several factors, including deregulation of the financial sector, technological innovation, and changes in corporate governance. Financialization has had several consequences for the

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economy, including increased inequality, instability, and environmental damage. The accumulation process is influenced by the interaction between corporate decision-making and the financial agents who have an interest in the firm. The two key sources of financing for companies are internal finance and debt. The accumulation rate is the sum of two terms: the rate of interest and the financial term. The financial term is the formed of the leverage factor (the economic rate of return minus the overall cost of capital) and also of leverage ratio itself. The equilibrium between the growth rate and the debt rates is a razor's edge equilibrium. If the manager's objective is the real growth of the company, the desired amount of debt at a given interest rate is not limited. Financial players, banks, and majority shareholders must limit the effective level of corporate debt.

The accumulation of capital is relatively low in the times of financialization, as non-financial corporations (NFCs) have become increasingly interested in investment in financial assets and discharging greater payment amounts on financial markets. NFCs are also pressured to raise financial markets' payments in the form of dividends and stock buybacks, which can lead to a decrease in funds available to support economic investment, a shortening of NFC management's time horizon, and increased uncertainty about the cost of reacquire financial resources in the future. These factors can have a detrimental impact on investment activity in companies. Sustainability reporting has become most popular in recent years as businesses look to demonstrate their commitment to social responsibility and environmental protection. The Brundtland report in 1987 defined sustainable development as "meeting the needs of the present without compromising the ability of future generations to meet their own needs." This report helped to raise awareness of the importance of sustainability and led to the development of sustainability reporting standards. Today, many businesses publish sustainability reports that outline their environmental, social, and economic performance. These reports can help businesses

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to improve their transparency and accountability, attract investors, and build trust with stakeholders.

There is a growing demand from stakeholders for businesses to disclose more information about their economic, environmental, and social performance. However, there is no single, universally accepted standard for sustainability reporting, and businesses often use different frameworks and criteria. The Global Reporting Initiative (GRI) is a leading sustainability reporting framework, and its guidelines categorize sustainability activities into six dimensions: economic, environmental, social, labor, goods and services, and human rights.

There are many different frameworks and standards for sustainability reporting, including GRI, AA1000, SA8000, ISO 14001, AS/NZS, EMAS, and OHSAS 18001. These frameworks and standards help businesses to measure and report their economic, social, and environmental performance. There is also a growing body of research that suggests that sustainability and financial performance are positively correlated, and that sustainability strategies can reduce risks or provide insurance cover for the intangible assets of a business.

There is a growing consensus that CSR-related managers are key players in promoting sustainability in business contexts. They can do this by using their leadership positions to influence organizational culture and decision-making, and by building relationships with stakeholders. Businesses can also use CSR strategies to improve their reputation and attract customers, investors, and employees. The European Union has recently adopted several measures to promote sustainable investment and management of financial risks, and organizations like the World Business Council for Sustainable Development have developed tools to help businesses align their strategies with the Sustainable Development Goals.

2.1 Proposed hypothesis

Hypotheses being used for Pakistani non-financial firms are as follow:

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H1: The relationship between financial payments and accumulation of real capital is significant

H2: The relationship between non-operating profit and accumulation of real capital is significant

H3: The relationship between buybacks and accumulation of real capital is significant

H4: The relationship between ENV and accumulation of real capital is significant

3. Research Methodology

Research design is the blueprint of a research project. It is a plan that outlines the steps that the researcher will take to collect and analyze data to answer their research question. The research design includes the researcher's philosophy, approach, strategy, choice, time horizon, and sampling technique. It is important to have a well-designed research project to enforce that the outcomes are accurate and reliable.The research approach is the way in which the researcher conducts the study. There are two main approaches: inductive and deductive. The current study uses a deductive approach, meaning of which is that the researcher starts with a theory and then tests it by collecting data. The research strategy is a general plan for conducting the study.

The current study uses a causal research strategy, which means that it investigates the direct and indirect effects of specific corporate governance (CG) attributes on financial performance (FFP) and environmental management (EM).Both the research approach and research strategy are important parts of the research design. They help the researcher to answer their research question in a systematic and rigorous way.

Before collecting data, it is important to select an appropriate and representative sample. This means that the sample should be representative of the entire population and not be biased towards any characteristic. The choice of sampling

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technique depends on the objectives of the study, the nature and size of the population, and the available resources.

Stratified random sampling is a type of probability sampling technique that is often preferred over other methods because it reflects the total population very accurately by giving an equal chance of selection to each unit of the population. In stratified random sampling, the population is first divided into different groups (strata) based on a shared characteristic, such as age, gender, or region. Then, a random sample is selected from each stratum.Stratified random sampling reduces sampling error and ensures a true and fair representation of the entire population. Therefore, it is a good choice for studies that require a high degree of accuracy and representativeness.In summary, sample selection is an important part of research design. Stratified random sampling is a good choice for studies that require a high degree of accuracy and representativeness.

This study will examine the changes and effects of sustainability reporting and financialization on the accumulation of real capital in businesses over a period of five years (2018-2022).The study will collect ESG and financial data of Pakistani non-financial firms and use an automated, data-driven, and objective logic to calculate the overall Thomson Reuters ESG score. This will allow the study to investigate the evolution and impact of sustainability reporting and financialization on real capital accumulation in businesses over a period of five years (2018-2022).

$$\ln\left(\frac{I}{TA}\right) = \alpha_0 + \beta_1 \ln\left(\frac{FP}{TA}\right) + \beta_2 \ln\left(\frac{NOP}{TA}\right) + \beta_3 \ln\left(\frac{Buybacks}{TA}\right) + \beta_6 \ln\left(\frac{ENV}{TA}\right)$$

The study will use a variety of statistical tests to analyze the data, including descriptive statistics, Pearson's correlation coefficient, variance inflation factor (VIF), and panel-data regression. This will allow the study to measure the linear dependence between the variables, identify multicollinearity, and assess the existence of endogeneity. The study will also use data diagnostics checks to ensure the robustness of the results.

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4. Data Analysis and Results

The random effect (GLS) regression results for the first model is represented in Table 5.12. The model examines the impact of corporate governance attributes (FINPAY, NONOPRPROFIT, BUYBACKS, ENVIROET) on real capital accumulation (ARC) measured by earnings multiple (pc1pc2).The Wald Chi2 (1) test and Prob > Chi2 test are used to examine the goodness-of-fit of the model. The Wald Chi2 (1) statistic is 67.48, with a Prob > Chi2 value of 0.000, which confirms the goodness-of-fit for the 1st model of study.The Durbin Watson statistic is used to test for autocorrelation in the model. The Durbin Watson statistic value is 2.07, which shows that there is no issues of autocorrelation, and the threshold value of Durbin Watson is equal to two (2) or near to two (2).In conclusion, GLS regression results are satisfactory for the 1st model of study. The model has a good fit to the data, and there is no evidence of autocorrelation.

Table 5.12: Random effect (GLS). Model. 1. (A to B)

ARC (pc1pc2)	**Coef.**	**Std. Err.**	**P**
FINPAY	0.015918	0.0238615	0.0505
NONOPRPROFIT	0.006267	0.0034157	0.067
BUYBACKS	-0.020221	0.0260399	0.437
ENVIROET	0.053702	0.0611343	0.380
LOGTASSETS	0.037894	0.0745221	0.411
SHAREMKETPRC	0.734122	0.0657167	0.000
MKTTOBV	0.197979	0.0499443	0.000
LEVERGE	-0.000439	0.0001797	0.014
IFRS	-0.111207	0.0820342	0.175
Cons	0.0227741	0.3119759	0.942
GLS			Random effect
Observations (320*5)			1600

R-Square		49.22
Years		Dummy
Industry		Dummy
Wald Chi(2)		67.48
Prob>Chi2		0.000
DW-Statistics		2.070
Durbin (score) Chi2(1)	1.23	0.110
Wu -Hausman F(1589)	1.54	0.134

* Significant at 10%, ** significant at 5%, and *** significant at 1%.

The Durbin (score) Chi2 (1) and Wu-Hausman F (1589) tests in Table 5.12 show no evidence of endogeneity in the 1st model of study. The p-values for both tests are greater than 0.05, which indicates that no endogeneity is present in the model. The R-square of 49.22 suggests that the independent variables (CG attributes) explain 49.22% of the variation in the dependent variable (ARC). In conclusion, the regression results for the 1st model of study are satisfactory. The model has a good fit to the data, there is no evidence of autocorrelation or endogeneity, and the independent variables explain a significant amount of the variation in the dependent variable.

Board of director size has a positive and significant impact on real capital accumulation, suggesting that it is important for Pakistani public listed companies to improve board of director size to boost real capital accumulation. Hence, because the impact of FINPAY was positive on firm ARC, the null hypothesis is accepted at the expense of the alternate hypothesis.The study finds that independent board of directors has a positive and significant impact on real capital accumulation, consistent with agency and stakeholders' theory. Therefore, based on the statistics presented in Table 5.12, the null hypothesis is accepted.

The study finds that there is a negative but insignificant relationship between BOD meeting and real capital accumulation, suggesting that BOD meeting did not

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play any significant role for improving real capital accumulation in Pakistani public listed companies during the years 2018-2022. Keeping the above discussion in view, the results evidence suggests rejecting the null hypothesis of the study.The study finds that there is no significant relationship between environment and real capital accumulation, suggesting that environment did not play any effective role in improving real capital accumulation in Pakistani public listed companies during the years 2018-2022. Therefore, based on the above finding and discussion, the empirical results in Table 5.12 reject the null hypothesis of this study.

5. Discussion and Conclusion

The study examined the complex relationship between financialization, sustainability reporting, and the accumulation of real capital in Pakistani non-financial firms. Findings of this study demonstrated consistency with the previous research. Pakistani non-financial firm's accumulation of real capital is examined by the impact of financial payments, non-operating profit, and buybacks. The results of the above observation demonstrated a positive and significant of financial payments on real capital accumulation which indicates that financialization plays a pivotal role in developing investment strategies of these firms. On the contrary, non-operating profits had positive but insignificant impact on real capital accumulation. Whereas buybacks showed negative and insignificant impact on the said variable which indicates that real capital investments are not significantly contributed by stock buybacks.

This study also examined the influence of corporate governance attributes on real capital accumulation. Results showed positive significant impact of board size on real capital accumulation indicating the importance of large board in elevating real capital investment. Similarly independent board members also showed same positive and significant impact on real capital accumulation which explains the agency and stakeholders' theories. Whereas frequency of board meetings did not show a significant impact on real capital accumulation.Impact of environmental factors on real capital accumulation also examined is this study. It is found that environmental factors had no significant impact on real capital accumulation. This insignificance of Pakistani firms raises questions about the environmental sustainability in these firms. More attention and efforts are required to incentivize and encourage environmentally responsible practices.These results and observations contribute to the growing body of literature which highlights the impact of financialization and sustainability reporting on corporate investment decisions. This research is also insightful for policymakers, managers, and investors to examine the factors influencing real capital accumulation and need for effective corporate governance practices.

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