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Issue Brief Series

AI Applications in ESG Practices and Reporting

Issue Brief Number: IB-2025-10

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Cite this Article as *Jha, S.(2025). AI Applications in ESG Practices and Reporting . Kautilya School of Public Policy [online]. Available at: https://kspp.edu.in//issue-brief/ai-applications-in-esg-practices-and-reporting*

AI Applications in ESG Practices and Reporting

Executive Summary

The ESG framework has rapidly evolved into a pivotal tool for organizations to balance sustainability with profitability and ethical practices. Artificial Intelligence is emerging as a transformative force in enhancing ESG practices by enabling precise data collection, minimizing reporting inaccuracies, and offering predictive analytics to inform strategic decisions. For example, products such as BlackRock Aladdin have shown the potential of AI in the optimization of ESG investment portfolios, which reportedly surpass traditional funds by 12% annually (McKinsey, 2022). AI comes with its set of challenges: algorithmic bias, data privacy issues, and systemic dependencies. This paper takes a dual-edged approach toward the role of AI in the revolutionization of ESG practices while considering risks and impacts on key stakeholders.

Sector and Sectoral Applications

Considering ESG as the sector of interest, in this section, I explore the ESG practices and framework and then proceed towards understanding the potential AI applications in this sector.

a. Explanation of ESG Practices and Framework

ESG is a comprehensive framework that measures how businesses manage the opportunities and risks associated with sustainability. Its three pillars are environmental, social, and governance. They measure how well a company is doing in areas that are critical to its long-term sustainability and ethical behaviour:

1. **Environmental Factors:** These include a business's carbon footprint, resource conservation efforts, and climate risk resilience. Such management is in a commitment to solving environmental problems and meeting the international climate target, including the Paris Agreement.
2. **Social Factors:** This factor examines relationships with supply chains, communities, and employees. Labour practices, diversity initiatives, and social equity contributions are some of the measures. Ethical sourcing and supply chain transparency are increasingly important in global markets.
3. **Governance Factors**: Governance addresses corporate leadership, board accountability, shareholder rights, and ethical decision-making. Good governance structures promote transparency and align leadership incentives with stakeholder expectations.

The evolution of ESG has its roots in the Environmental, Health, and Safety (EHS) regulations of the 1980s, expanding to Corporate Social Responsibility (CSR) in the 1990s, and finally maturing into a proactive, data-driven framework in the 2010s. Today, ESG is integral to investment decisions, with ESG-linked financial instruments like green bonds and sustainability-linked loans incentivizing corporate responsibility. ESG-mandated assets are projected to constitute half of all professionally managed assets globally by 2024, underscoring the framework's growing influence in financial markets. (Deloitte, 2024)

b. Potential for AI Application in ESG

AI has emerged as a powerful enabler in overcoming the challenges inherent in ESG practices, offering data-driven solutions for risk management, compliance, and strategic planning:

1. **Data Collection and Integration**:
    - AI systems streamline ESG data collection from diverse sources, reducing reliance on manual processes. 55% of companies cite data complexity as a barrier to effective ESG implementation. (PwC, 2023)

- Tools like SiaGPT use generative AI to extract and categorise ESG metrics, enabling real-time insights and compliance with global frameworks such as the EU's Corporate Sustainability Reporting Directive (CSRD).

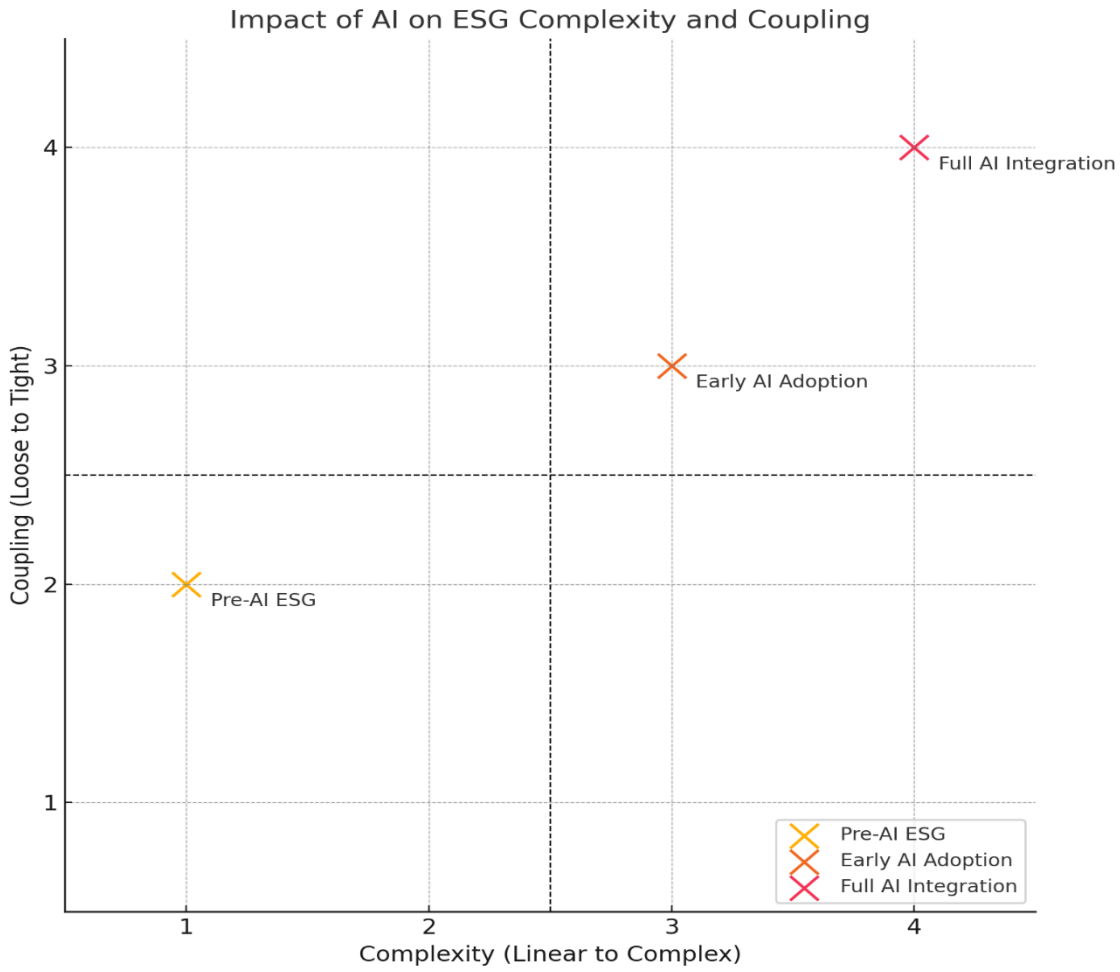
2. **Improved ESG Reporting**:
    - NLP technologies convert ESG metrics into simple, stakeholder-specific narratives. According to Deloitte's 2024 Global ESG Report, AI-based reporting cut down the number of human errors by 40% for companies that used such technologies.
    - Generative AI platforms automatically generate ESG disclosures, which are aligned with stakeholder priorities and regulatory standards.
3. **Risk Assessment and Management**:
    - Risk modelling powered by AI can help detect and address climate-related supply chain disruption, among others. The World Economic Forum (2024) reveals that operational losses of early adopters declined by 30% because of risk modelling powered by AI.
    - AI can help generate climate risk analytics and, thus, give actionable information to those sectors of industries most exposed to environmental shocks.
4. **Investment Decision Support**:
    - Platforms like BlackRock Aladdin utilise AI to analyse ESG risks that inform sustainable investment strategies. AI-optimized ESG portfolios have beaten traditional funds by 12% annually as of 2023. (McKinsey, 2022)
    - AI-driven ESG scoring frameworks help ensure capital flows toward high-performing, sustainable enterprises.
5. **Operational Efficiency and Emission Reduction**:

- AI-driven tools monitor energy use and carbon emissions, enabling organizations to meet net-zero commitments. Google's AI-powered data centre cooling system achieved a 30% reduction in energy consumption, as reported by the International Energy Agency (2023).Blockchain integrated AI enhances Scope-3 emissions tracking, ensuring transparency across supply chains.

6. **Scenario Analysis and Strategic Planning**:
    - AI tools simulate ESG scenarios, assessing the long-term impacts of strategic decisions. For instance, Microsoft's AI models evaluate the financial and environmental benefits of transitioning to renewable energy sources.
    - Scenario planning tools enable companies to navigate evolving regulatory landscapes and market demands effectively.
7. **Global ESG Trends**:

- AI enhances geographic and sector-specific ESG trend analysis. Figure below highlights regions leading in ESG investments, reflecting global variations in regulatory emphasis and market maturity.

c. Systems Perspective: Change in Complexity and Coupling



From a system perspective it is very evident AI integration introduces complexities and interdependencies in ESG processes. This is explained as follows:

1. **Complexity:**
    - ESG data spans environmental metrics, social indicators, and governance benchmarks. AI algorithms must reconcile these multidimensional datasets to deliver actionable insights.
    - Evolving regulatory requirements necessitate frequent AI model updates, increasing system complexity.

2. **Coupling**
    - AI systems link ESG processes across compliance, reporting, and stakeholder engagement. Failures in one area can cascade, amplifying organisational risks as there are no contingencies or buffers for human intervention in the process.
    - Over-reliance on AI for decision-making without human oversight may erode trust and accountability.

3. **Discussion on the Potential Risks and Impact Groups**

a. Impact Groups of AI Applications in ESG

There are four primary groups are impacted by the adoption of AI in ESG practices:

1. **Corporate Stakeholders**:
    - This entails the executives, managers, and employees who ensure that the organization is implementing an ESG approach. AI would facilitate better decisions and operational efficiencies by streamlining reporting and providing predictive analytics. Nonetheless, algorithmic bias may render the ESG scores biased towards certain firms and disadvantage smaller or less represented areas.
2. **Regulators and Policymakers**:
    - Regulators benefit from AI's ability to enhance compliance monitoring and enforce ESG standards. Predictive analytics help policymakers anticipate regulatory impacts. However, opaque algorithms and biases can hinder transparency and complicate enforcement.
3. **Communities and Society**:
    - Communities are directly impacted by AI-driven ESG practices, benefiting from enhanced resource allocation and predictive environmental risk analysis. However, ethical concerns also come when community-level data is used without proper consent, which can potentially lead to privacy violations and erosion of public trust.

4. **Investors**:
    - AI provides investors with comprehensive ESG insights, improving their ability to allocate capital toward sustainable ventures. However, over-reliance on AI models may neglect qualitative factors, limiting comprehensive risk evaluation.

b. Impacts of Technology Interventions on Impact Groups

The potential AI inclusions have both negative and positive impacts:

1. **Positive Impact**
    - Accountability: AI-based solutions offer stakeholders transparent, data-driven insights, which helps build trust and enhance accountability in ESG practices.
    - Efficiency Gains: AI saves considerable time and cost by automating complex ESG reporting processes, thus enabling management to make faster, better-informed decisions.
    - Proactive Risk Management: Predictive analytics help organizations anticipate and mitigate risks such as regulatory violations or reputational threats before they become unmanageable.

2. **Negative Impacts**
    - Algorithmic Bias: AI models can potentially entrench systemic biases, thereby jeopardizing the broader objectives of ESG. The smaller firms or underrepresented regions with fewer data points will have an unfair disadvantage.
    - Privacy: The use of sensitive community-level data raises concerns about consent and data security. Breaches could also damage corporate reputations and dent stakeholder trust.

- Human Oversight Reduced: Overreliance on automation may reduce human judgment in matters of importance, thereby increasing the chances of misinterpretation or ethical blind spots in ESG decisions.

Furthermore, there are other risks that remain latent, and many have yet to be discovered, such as AI-led greenwashing, plus a reliance on closed-source algorithms. These must all be taken seriously under the kind of strict regulation guidance and ethical safeguards to ensure that AI is really a driver towards the latter's sought improvement of ESG.

Policy Recommendations

- **Standardized AI Governance for ESG** - the Business Responsibility and Sustainable Reporting (BRSR) framework can be expanded by SEBI to also include AI-driven disclosures processing to enhance accountability in ESG data processing. It can be overseen by a regulatory body under the respective ministries to oversee AI applications in ESG reporting and ensure alignment with international standards.
- **Bias-Free AI Algorithms for ESG Scoring** – To prevent bias against MSMEs and emerging markets, the AI systems used in ESG scoring should be regulated promptly. Niti Aayog in collaboration with industry stakeholders can establish AI ethics and relevant guidelines, mandating third-party audits of AI driven assessments to ensure fairness.
- **Tax Benefits and Subsidies** can be provided to companies adopting AI systems to implement energy efficient systems, lower emissions and enhance ESG compliance, special incentives can be directed to high emission industries like energy, manufacturing, and transport to drive sustainable transformation.

- **AI-Powered Climate Risk Analytics** should be advised for companies in climate sensitive sectors to better assess long term risks, which will further guide public investments and private sector adaptation strategies.

Conclusion

AI integration into ESG initiatives is a game changer for corporate America. It places companies ahead of the curve regarding sustainability, improved operational efficiencies, and superior decision-making. From more streamlined data collection to more effective reporting to superior predictive abilities, AI can change how companies reach their ESG objectives. One of the major systems is BlackRock's Aladdin system. Yet, among all the benefits, some drawbacks come into play that must be considered. The vulnerability that ESG faces with the introduction of AI introduces some risks. Ultimately, the future of AI and ESG relies upon the ethical application of such technology for transparent operations, increased accountability, and stakeholder trust. Those companies involved must focus on ethical safeguards and champion efforts to proactively engage stakeholders in the increasingly complex socio-economic realities that AI-driven ESG will create.

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