Enhanced Analytics

ESG & Credit Risk; New Study Demonstrates a Clear Link

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Steve Lohr wrote in an opinion piece about the merits of corporate social responsibility (CSR) in the New York Times: "Corporate social responsibility efforts have always struck me as the modern equivalent of John D. Rockefeller handing out dimes to the common folk. They may be well-intentioned, but they often seem like small gestures at the margins of what companies are really trying to do: make money."[1]

Although Lohr went on to defend CSR initiatives, his statement neatly summarizes the oft-echoed sentiments of CSR naysayers – that efforts to do good while making money amount to little more than "PR-hogwash".[2] Perhaps one of the longest-standing debates in the history of CSR is whether or not it is even ethical for companies to pursue CSR agendas at the possible expense of financial performance.

But a new study[3] by the Swiss Federal Institute of Technology and the University of Hamburg lends credence to the argument that companies not only can, but in fact do, do better when doing good. The study, which was awarded the best student paper at the UN PRI Academic Network Conference this past November, marks the first research of its kind to prove a clear link between environmental, social and governance (ESG) risks and credit risk. Using data contributed by RepRisk, a Swiss-based ESG business intelligence provider, the authors examined the effect of CSR-related negative media attention on credit default swap spreads.

The results may not be surprising for proponents of CSR, but does much to discredit Miltonian arguments that CSR is essentially incompatible with capitalism.[4] According to the study, companies that are criticized in the news for irresponsible ESG practices have higher credit default swap spreads, suggesting that a firm's poor reputation when it comes to CSR issues could have a significant impact on its financial performance. In fact, the study found that just one additional negative news item in a leading business paper resulted in an average increase of three percent of the credit default swap spread by the following quarter.

On a practical level, this means that information on ESG risks is relevant for fixed income investors. "The results are part of a growing body of literature suggesting that ESG factors can enhance investment value and help mitigate risks," explains RepRisk CEO Philipp Aeby. "Investors

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are increasingly coming to the conclusion that companies that take concrete measures to mitigate ESG risks often have superior governance structures."

Prior to the Deepwater Horizon oil spill in April 2010, for example, investors expressed confidence in BP's long-term growth prospects. In 2009, BP had increased production of oil and gas, discovered huge oil reserves amounting to more than it had produced in a year, made bigger than expected cost cuts, and reported third-quarter profits well ahead of expectations. [5]

From an ESG perspective however, the company's performance had been disconcerting. In the two years prior to Deepwater Horizon, RepRisk highlighted significant risk exposure for BP due to frequent and severe criticism on ESG issues such as occupational health and safety issues, environmental pollution, negative impacts on local communities and labor issues. In fact, RepRisk had captured more criticism related to occupational health and safety issues at BP than at five of its major competitors combined.

The consequences of ignoring BP's track record of negligent behavior are, at this point, well-known. The explosion at the Deepwater Horizon oil rig killed eleven workers in what experts have described as the worst environmental disaster in US history. It also resulted in BP's stock plummeting nearly 40 percent – an estimated USD 75 billion in shareholder value – within months.[6]

The debate about CSR has changed drastically over time: four decades ago, the general consensus among CSR skeptics was a resounding "the business of business is business", a quote that has been oft attributed to the father of neoliberal economics, Milton Friedman. These days, you are unlikely to come across that kind of sentiment strewn across the pages of many business publications. Instead, one is more likely to come across terms such as "shared value" and "triple bottom line".

But incidents like the Deepwater Horizon oil spill have brought to surface debates about the relevance and impact of voluntarily corporate responsibility efforts. Business leaders and investors alike must draw the line between those initiatives that can be aptly-dismissed as "PR-hogwash" and earnest attempts by corporate executives to drive sustainable reform across an organization. After all, CSR really is about much more than "handing out dimes to the common folk." As the recent research linking credit risk and CSR demonstrated, companies can do well – vis-à-vis society, the environment, their employees, and of course, their shareholders and investors – by doing good.

[1] http://www.nytimes.com/2011/08/14/business/shared-value-gains-in-corporate-responsibility-efforts.html?pagewanted=all
[2] http://www.corporateknights.com/article/naysayers
[3] http://www.reprisk.com/study-based-on-reprisk-data-wins-award-for-excellence-in-responsible-investment-research/
[4]http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html
[5] http://news.bbc.co.uk/2/hi/business/8327254.stm
[6] http://content.time.com/time/interactive/0,31813,2006455,00.html