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Original Paper

A Theoretical Study of the Impact of ESG Performance on the Cost of Corporate Debt Financing

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Abstract

With the increasing global attention to environmental protection, social responsibility and corporate governance (ESG) issues, the ESG performance of enterprises has become an important indicator for creditors to assess their non-financial performance. This paper analyzes the development status quo of ESG ratings in China and the situation of corporate debt financing, combines information asymmetry theory, principal-agent theory, contract theory and other in-depth discussion of the impact of corporate ESG performance on its debt financing costs, so as to put forward targeted recommendations to further enhance the attention of China's listed enterprises to ESG ratings, as well as to reduce the cost of corporate debt financing measures put forward to lay a more solid theoretical foundation, to help enterprises better achieve high-quality and high quality of corporate governance. It lays a more solid theoretical foundation for further improving China's listed enterprises' attention to ESG ratings and proposing measures to reduce the cost of corporate debt financing, and helps enterprises better realize high quality and sustainable development.

Keywords

ESG rating, Debt financing costs, Information asymmetry theory, Principal-agent theory, Contract theory

1. Introductory

In recent years, the concept of sustainable development has taken root in people's hearts and has become a common topic for all mankind. The ESG performance of enterprises has been receiving more and more attention from investors, creditors and regulators, and the origin of the ESG concept can be traced back to the social responsibility movement that emerged in the United States and Europe in the early 1970s, which advocated that enterprises should not just pursue economic profits, but also take the initiative to assume responsibility for the society and the environment. Since then, many enterprises have begun to care about their own economic development and related social responsibility, and gradually added environmental and social factors into the consideration of business decision-making, and eventually formed the enterprise's unique values and principles of operation.

As a significant consideration in corporate financing activities, debt financing directly impacts a company's daily operations and investment decisions, and also has a substantial influence on its long-term development and market competitiveness. Therefore, exploring the relationship between ESG (Environmental, Social, and Governance) and debt financing costs is of great significance for understanding the impact of ESG performance on corporate financial decisions, optimizing corporate financing structures, and reducing financing costs. Based on the above analysis, this paper theoretically examines the influence of corporate ESG performance on its debt financing costs. It aims to provide a new theoretical perspective on the impact of ESG performance on corporate debt financing costs, serving as a reference for corporate ESG development and financing decisions.

2. Status of ESG development in China

Nowadays, China's economic development has entered a new era, and has shifted from a stage of high-speed growth to a stage of high-quality development, which is a strategic choice to meet the requirements of sustainable development in the world. At present, there are frequent global challenges and the issue of sustainable social development is prominent. Nature is not inexhaustible. Only by handling the relationship between human beings and nature and maintaining the balance of the ecosystem can human health be safeguarded. General Secretary Xi Jinping emphasized that humans and nature should coexist harmoniously. When humans protect nature in a friendly manner, the rewards of nature are generous; When humans brutally plunder nature, the punishment of nature is also merciless. So it is even more important to respect, conform to, and protect nature, and build a harmonious coexistence between humans and nature as a home on Earth. China adheres to the path of high-quality development, does not follow the old path of pollution first and then treatment, and does not follow the last resort of exhausting resources. It pursues harmonious coexistence between humans and nature, and promotes sustainable economic and social development.

Under China's top-down governance framework, ESG information disclosure, ESG ratings, and ESG investments have rapidly developed. The Chinese government has issued a series of guidance documents to promote good performance by enterprises in terms of environmental protection, corporate governance, and corporate social responsibility. As early as 2002, the China Securities Regulatory Commission (CSRC) issued the "Corporate Governance Code for Listed Companies," which clearly stipulates the scope of disclosure for corporate governance information of listed companies. This Code has had a significant impact on advancing the standardization of information disclosure by listed companies. In 2008, the State Environmental Protection Administration officially issued the "Guiding

Opinions on Strengthening the Supervision and Management of Environmental Protection for Listed Companies," guiding listed companies to actively fulfill their environmental protection responsibilities and obligations, promoting them to continuously improve environmental protection measures, and accelerating the establishment of environmentally friendly enterprises. In 2018, the China Securities Regulatory Commission (CSRC) revised the "Corporate Governance Code for Listed Companies," adding a new chapter on "Stakeholders, Environmental Protection, and Social Responsibility." This revision stipulates that listed companies shall disclose ESG content in accordance with laws, regulations, and the requirements of relevant departments. It also mentions "actively drawing on international experience, promoting institutional investors' participation in corporate governance, strengthening the role of the audit committee of the board of directors, and establishing a basic framework for information disclosure on environment, social responsibility, and corporate governance (ESG)." This formally kicked off the regulation of ESG investments in the Chinese market.2023 In March 2023, the China Corporate Social Responsibility Reporting Committee (CSRRC) led the compilation of the “China Corporate ESG Report Rating Standard (2023)” was officially released, which further improved the ESG working mechanism, and actively constructed ESG disclosure rules, performance ratings and investment guidelines with Chinese characteristics.

3. Status of Debt Financing of Listed Enterprises

The bond market is a place where bonds are issued and traded, and is an important and indispensable part of the financial market. In recent years, the pace of China's bond market opening up to the outside world has accelerated, and the policy environment has been continuously optimized, attracting a large inflow of foreign capital and enabling foreign investors to invest in China's bond market more conveniently. At the same time, bond varieties have become increasingly rich, including treasury bonds, local government bonds, corporate bonds, financial bonds, etc., providing investors with diversified investment choices. In addition, China has also actively promoted the internationalization of the RMB, providing more convenience for foreign investors to invest in the Chinese bond market. The Chinese government has also played an important role in the development of the bond market. The government has provided a strong guarantee for the healthy development of the bond market by formulating relevant policies and regulations, strengthening market supervision and enhancing market transparency. At the same time, the government also actively promotes innovation in the bond market and encourages enterprises to issue new types of bonds, such as green bonds and social responsibility bonds, to support sustainable development and green finance.

By the end of 2023, China's bond market has issued a total of 71 trillion yuan of various types of bonds, an increase of 14.8%, making it the second largest bond market in the world. Financing is crucial to the survival and development of enterprises. At present, the main financing channels of enterprises are equity financing and debt financing. For most enterprises, although equity financing has the financial pressure of long fund use period and no periodic repayment, it will also disperse the control of enterprises, and the capital cost is high, and the information disclosure requirements of enterprises are strict, so it is not suitable for all enterprises. Debt financing has advantages such as effectively reducing a company's average capital cost, generating financial leverage effects, rapidly raising funds, and maintaining corporate control rights. Therefore, the proportion of debt financing in China is higher than that of equity financing. However, despite the fact that the government has taken a series of measures since the reform and opening up to improve the financing environment of enterprises and to help solve their financing problems, such as developing small and medium-sized financial institutions, setting up multi-level specialized SME investment companies, and providing enterprises with better financing services, the problems of “difficult and expensive financing” have been plaguing the development of China's economic market, and have become a major problem affecting the long-term development of enterprises. The problem of “difficult and expensive financing” still continues to plague the development of China's economic market and has become a major problem affecting the long-term development of enterprises. Nowadays, China is in the midst of unprecedented changes in a century, and the sustainable and high-quality development of the economy has put forward higher requirements for enterprises. How to reduce the financing cost of enterprises, improve the business performance of enterprises, and promote the high-quality development of enterprises is crucial.

4. Theoretical Analysis of the Impact of ESG on Corporate Debt Financing

4.1 Information Asymmetry Theory

The phenomenon of information asymmetry was first studied by American economist G Akerlof George Akerlof, M Spence Michael Spence and J E. Stigliz and Joseph Stiglitz's concerns and research. These three economists studied this topic from three different fields: commodity trading, labor force, and financial markets, providing a new perspective for the market economy. According to the theory of information asymmetry, it is believed that in market transactions, the degree of information control of the two parties involved in the transaction is different, with information differences. Generally speaking, the seller knows more about their own products, including product cost, quality and performance, than the buyer. Enterprises also know more about their own company's situation than external consumers. This information difference leads to unequal status between the two parties in the market. The party with more information can benefit from the market by transmitting reliable information to the party with less information, resulting in an imbalance of interests between the two parties in the market, which may also lead to "moral hazard" and "adverse selection", affecting the principles of fairness and justice in society and the efficiency of market resource allocation.

Therefore, good ESG performance of enterprises can help improve information transparency and reduce the degree of information asymmetry between enterprises and investors. By disclosing detailed ESG related information, companies can convey positive signals about their environment, society, and corporate governance to the market, enabling investors to have a more comprehensive and accurate understanding of the company's operating conditions and future development prospects. The competitive disadvantage of ESG will increase the debt financing cost of enterprises by raising their level of information asymmetry, and this phenomenon is more pronounced in private enterprises with relatively closed information transmission. Asymmetric information in enterprises can hinder creditors from making accurate judgments about the future cash flow and operating conditions of the enterprise, and greatly reduce the liquidity of bonds, leading debtors to demand higher risk return on their investments. Conversely, if enterprises are compelled to present the internal research and development (R&D) expenses and their detailed items within the company, it is conducive to reducing the asymmetry level of internal and external information, allowing creditors to have a better understanding of the company's R&D activities and subsequently lowering their financing costs. Enterprises can also mitigate the information asymmetry between themselves and banks by disclosing the taxpayer credit ratings, thereby assisting enterprises in obtaining financing at a lower cost. Therefore, the improvement of enterprise information transparency is helpful in enhancing investors' trust in enterprises, thereby reducing investors' requirements for risk premiums and further lowering the debt financing costs of enterprises.

4.2 Stakeholder Theory

According to stakeholder theory, the theory can be traced back to Penrose's Theory of Enterprise Growth published in 1959, in which he put forward the idea that “the enterprise is a collection of human assets and human relationships”, laying the foundation for stakeholder theory. The theory holds that an enterprise is a collection of stakeholders, including shareholders, creditors, employees, consumers, suppliers and other trading partners, as well as government departments, local residents, communities, the media, environmental organizations and other pressure groups, and even the natural environment, future generations of human beings and other objects directly or indirectly affected by the enterprise's business activities. These stakeholders are closely related to the survival and development of the enterprise, and their interests must be taken into account or their constraints must be accepted in the enterprise's business decisions.

A better ESG performance can lead to greater managerial discipline and stronger social responsibility, which can help reduce financial restatements and true earnings management in a subjective sense, thereby improving the company's financial discipline level. At the same time, good ESG performance can also accumulate more social reputation by releasing non-selfish positive signals, thereby enhancing the confidence of creditors and external investors. The improvement of investor confidence can help lower the company's financing costs, as investors are more willing to provide funding support to reputable companies and accept lower return rates. Companies with low ESG scores may face dissatisfaction and lawsuits from stakeholders due to environmental destruction, social injustice, or poor corporate governance, thereby increasing their legal and financial risks. On the contrary, companies with high ESG ratings, because they pay more attention to environmental protection, social responsibility, and good governance, can reduce such risks. These companies can reduce the potential conflicts and legal disputes with stakeholders by taking proactive ESG policies and practices. They can also improve their reputation and credibility, making it easier for creditors to trust them, thereby lowering their debt financing costs. In the study of the relationship between family ownership and ESG transparency in Italian companies, it was found that family-owned companies, due to their focus on privacy and legacy.

4.3 Principal-agent Theory

According to the principal-agent theory, the principal-agent theory arose in the 1930s and was pioneered by American scholars Burley and Milne in 1930. Its basic meaning is that the principal maximizes the interests of both the agent and the principal through the use of certain measures, and its essence belongs to the category of incentive compatibility issues. With the development of productive forces and the refined division of labor in the market, the owners of the rights are difficult to exercise their rights due to their ability or other reasons, so they will hire more specialized agents to exercise their rights instead of them, which leads to the separation of the ownership and management rights, and then gives rise to the principal-agent relationship. In a principal-agent relationship, the agent is the person who is entrusted to perform the task, while the principal is the person who entrusts the agent to perform the task. Their respective rights and obligations are stipulated through an express or implied contract between them. But there is often a conflict of interest between the agent and the principal. In order to resolve such conflicts, the principal needs to design effective incentives to motivate the agent to act in the principal's interest. Such incentives usually include compensation in the form of salaries, bonuses, stock options, and so on.

The root of the principal-agent problem lies in the divergence of interests between the owner and the operator of the enterprise. This divergence may prompt operators to make decisions that harm the overall well-being of the enterprise, which in turn leads to agency costs, which indirectly increases the debt financing burden of the enterprise. The soundness of the corporate governance structure plays a key role in alleviating such principal-agent problems. In the principal-agent relationship, creditors, as the providers of funds, need to face the risk of possible default by the enterprise. Enterprises with good ESG performance can reduce this risk by strengthening their practices in environmental, social, and corporate governance, thereby enhancing the confidence of creditors and reducing the cost of debt financing. A good ESG rating information disclosure mechanism can also significantly reduce information asymmetry and effectively reduce the cost of principal-agent. With the increase of equity concentration, the separation of ownership and control is also deepened, which often leads to the controlling shareholders are more likely to take actions that are detrimental to the rights and interests of small and medium-sized shareholders, which in turn pushes up the financing cost of the company. The principal-agent problem induced by corporate debt financing will affect the execution price of the real options implied by the project, leading to excessive investment advancement and scale of investment, which in turn will have many negative impacts on the value of equity, optimal capital structure, and external financing conditions of the enterprise in various dimensions. And within the enterprise, although large shareholders' holding can alleviate the agency problem between owners and managers to a certain extent, it will exacerbate the second type of principal-agent problem, i.e., the higher the proportion of shareholding among large shareholders within the company, on the contrary, it may reduce the principal-agent cost. Therefore, companies with excellent ESG performance usually have excellent internal control capabilities, which can effectively avoid multiple risks, thus cutting down the agency costs of the company, mitigating operational risks and losses, and laying a solid foundation for the long-term development of the company.

4.4 Contract Theory

According to the contract theory, when enterprises demonstrate outstanding performance in ESG (environment, social, and governance), the degree of perfection of their contracts is significantly improved. By incorporating ESG clauses into contracts with creditors, enterprises can clearly define the boundaries of their rights and obligations in terms of environmental responsibility, social responsibility, and corporate governance. This effectively reduces the challenges of moral hazard and adverse selection arising from information asymmetry. Furthermore, enterprises with outstanding ESG performance are generally more committed to the execution of contracts, actively implementing the agreements reached with creditors, ensuring that their commitments in areas such as environmental protection, social responsibility fulfillment, and corporate governance are actually fulfilled, thereby enhancing the credibility of enterprises in the eyes of creditors and reducing their debt financing costs. Such enterprises achieve effective regulation of their own behavior by formulating and implementing a series of policies and standards closely related to ESG, ensuring that their actions conform to the general expectations of society and strict regulations. This not only helps to reduce the operating risk exposure of enterprises, but also improves the availability and cost-effectiveness of debt financing. For enterprises that place more emphasis on contractual relationships, the probability of agency problems and moral hazard events is relatively smaller, such as non-state-owned shareholders holding stakes in state-controlled listed companies, optimizing the equity structure and corporate governance structure, and effectively alleviating internal control problems and other agency problems through enhancing the supervisory role of equity, thereby improving the enterprise's governance efficiency and innovative development capabilities.

5. Policy Recommendations

5.1 Actively Improving ESG Performance

For enterprises, many countries and regions have developed regulations and policies related to ESG, requiring enterprises to disclose ESG information. This is not only a moral responsibility, but also a legal obligation, and this trend will become more obvious in the future. More and more investors and shareholders are incorporating ESG into their investment decision-making process. They believe that companies with good ESG performance are more sustainable in the long term and are likely to earn higher returns. ESG requires companies to think about long-term sustainability, which can spur innovation. By finding environmentally friendly solutions, improving resource efficiency, managing potential risks, reducing non-compliance or irresponsible behavior, and enhancing a company's brand image with investors and consumers, there are many benefits to a company. Therefore, enterprises should enhance their understanding of ESG, deeply implement ESG concept, and strive to improve ESG performance.

5.2 Accelerating the Construction of ESG System

For regulatory bodies, ESG rating results serve as an important reference for domestic and foreign investment institutions to assess corporate ESG performance. Their impact on corporate financing costs, corporate image, and other aspects is increasingly significant today. Strengthening the construction of an ESG evaluation system with Chinese characteristics is a crucial aspect of advancing ESG infrastructure. Currently, mainstream ESG rating systems include FTSE Russell, CSI ESG Research, Sino-Green Ratings, and Social Investment Alliance, among others. However, these rating systems lack uniformity in standards, leading to significant differences in rating results. Therefore, capable state-owned listed companies can enhance their cooperation and exchanges with domestic and foreign ESG rating agencies, participate in and support the development of a local ESG rating system that aligns with international standards and national conditions. By doing so, they can promote the ESG information disclosure system for listed companies in China from the top down, establish a comprehensive and unified disclosure framework, facilitate the indexing and quantification of corporate ESG disclosures, and improve the continuity and comparability of information disclosure. Third, buttress the international ESG disclosure standards, and consider diversified and systematic environmental indexes to gradually expand the framework to ensure the effectiveness of the system. The ESG disclosure standards should be aligned with international ESG disclosure standards, combined with the implementation of the environmental information disclosure system for enterprises and institutions and the environmental credit evaluation system, and the framework should be gradually expanded to ensure effectiveness, taking into account the diversified and systematic nature of environmental indicators.

At the same time, regulators should also actively create an environment for ESG utilization, such as strengthening supervision to ensure that companies not only disclose their ESG performance, but also act in line with the disclosure. For companies that fail to disclose their ESG performance or do not disclose truthfully, certain penalties can be imposed to provide incentives and reminders. In addition, multi-party participation can be encouraged, with multiple stakeholders, including non-governmental organizations, industry associations, and academic institutions, participating in ESG practices to jointly promote sustainable development; and policy support and incentives can be provided to encourage enterprises to actively fulfill their social responsibilities and invest in environmental and social projects through tax incentives, financial subsidies, and other means.

In summary, this paper reveals the intrinsic connection between ESG performance and debt financing cost from a theoretical perspective, and also provides valuable reference basis for policy makers, corporate management and investors. In the context of promoting high-quality economic and social development, strengthening ESG management and promoting a green, low-carbon and sustainable financing environment will be the key path to achieve win-win development.

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