ESG and company profitability: Are financial intermediaries different?

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Outline

ESG and company profitability:
Are financial intermediaries different?

Research Questions

- How much is ESG associated with company profitability?
- Which are the dimensions of ESG that drive profitability the most?
- Are there differences and similarities between industrial and financial companies?

Outline

Acronyms: CSR vs ESG

Corporate Social Responsibility (CSR)

EC has defined CSR as the responsibility of enterprises for their impact on society and, therefore, it should be company led. Companies can become socially responsible by:

- Integrating social, environmental, ethical, consumer, and human rights concerns into their business strategy and operations;
- Following the law.

Environmental Social Governance (ESG)

ESG is the consideration of environmental, social and governance factors alongside financial factors in the decision-making process.

- ESG demands metrics.

Outline

CSR and ESG in the theory of the firm

Instrumental stakeholder theory

It is identified as part of the "good management theory" (Waddock & Graves, 1997)

Resource-based view

Environmentally or socially responsible activities may better attract qualified employees (Fatemi, Glaum, & Kaiser, 2017; Korschun, Bhattacharya, & Swain, 2014)

CSR, ESG and company performance

No relationship

- Aupperle et al. (1985): different dimensions of CSR (economic, legal, ethical, and philanthropic responsibilities) and financial performance are not statistically significant related
- McWilliams & Siegel (2000) claim that CSR has a neutral impact on financial performance

Negative relationship

- Friedman (1970) posits that ESG performance has limited financial benefits for companies because of the implementation cost that shareholders have to pay, leading to a misallocation and misappropriation of valuable company resources

CSR, ESG and company performance

Positive relationship

- Mackey (2005): "a certain amount of corporate philanthropy is simply good business and works for the long-term benefit of the investors"
- Eccles et al. (2014): high-sustainability companies significantly outperform their counterparts, both in terms of stock market and accounting performance
- Waddock & Graves (1997): virtuous cycle linking the implementation of ESG practices and financial performance
- Meta-analysis: Orlitzky et al. (2003); Margolis et al. (2009): ESG awareness is related with high firm performance

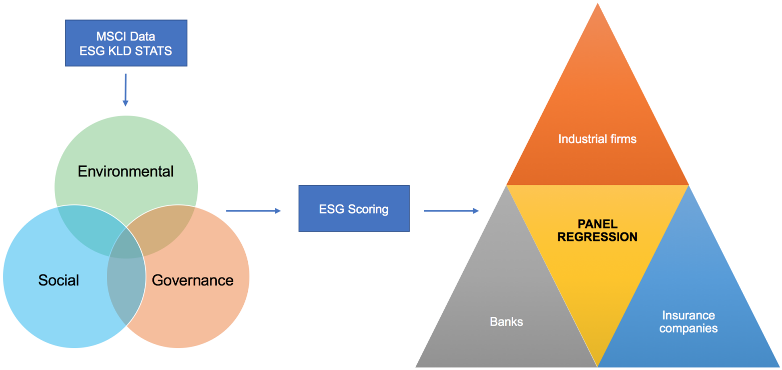
CSR, ESG and company performance

Financial and non financial firms

- Effect on reputaion:
    - Forcadell & Aracil (2017); Fayad et al. (2017): CSR in general is positive
    - Konar & Cohen (2001): environmental is positive
    - Simpson & Kohers (2002): social is positive
    - Dell'Atti et al. (2017) social is positive; governance and environment are negative
- Maqbool & Zameer (2018): find that CSR exerts a positive impact on financial performance. The authors suggest further studies on two aspects:
    - **Different dimensions of ESG activities and financial performance**
    - **Differences across industries**

Outline

Strategy of investigation



Model

Scoring

- $EScore = \frac{1}{n}\sum_{i=1}^{n} E_i$
- $SScore = \frac{1}{n}\sum_{i=1}^{n} S_i$
- $GScore = \frac{1}{n}\sum_{i=1}^{n} G_i$

- $ESGScore = \frac{1}{3}(EScore + SScore + GScore)$

Panel regressions

- $ROA_t = \alpha + \beta_1 ESGScore_t + \beta_2 \ln(TA) + \epsilon$
- $ROA_{t+1} = \alpha + \beta_1 ESGScore_t + \beta_2 \ln(TA) + \epsilon$

- $ROA_t = \alpha + \beta_1 EScore_t + \beta_2 SScore_t + \beta_3 GScore_t + \beta_4 \ln(TA) + \epsilon$
- $ROA_{t+1} = \alpha + \beta_1 EScore_t + \beta_2 SScore_t + \beta_3 GScore_t + \beta_4 \ln(TA) + \epsilon$

Outline

ESG Data

MSCI ESG KLD STATS

- Sample: more than 50,000 observations of US companies
- Period: 2000-2016
- **Environment** dimension: Climate Change; Environmental Management Systems; Biodiversity & Land Use; Raw Material Sourcing; and Water Stress
- **Social** dimension: Cash Profit Sharing; Employee Health & Safety; Employee Involvement; Human Capital Development; Human Rights Policies & Initiatives; Product Safety And Quality; Access To Finance; and Supply Chain Labor Standards
- **Governance** dimension: Gender; Corruption & Political Instability; Financial System Instability; Limited Compensation; Ownership Strength; Political Accountability Strength; Public Policy; and Reporting Quality

Financial Data

BvD Osiris

- Observed variable: Return on Assets (ROA)
- Control: Total Assets

$\Downarrow$

FINAL SAMPLE

- Companies: 3,476
- Observations: 17,358
  - Industrial companies: 16,159 (93% of the total sample)
  - Banks: 848 (5%)
  - Insurance companies: 351 (2%)

Results

Panel 1 – Total sample

	ROA_t	ROA_{t+1}	ROA_t	ROA_{t+1}
ESGSCORE	7.562***	6.361***		
lnTA	1.118***	0.623***	1.101***	0.615***
ESCORE			1.140	1.151
SSCORE			6.609***	4.923***
GSCORE			1.328	1.368*
_cons	-12.16***	-4.442***	-12.00***	-4.421***
N	17,358	12,476	17,358	12,476
adj. RSq	0.31	0.14	0.32	0.14

Panel 2 – Industrial companies

	ROA_t	ROA_{t+1}	ROA_t	ROA_{t+1}
ESGSCORE	6.671***	5.644***		
lnTA	1.407***	0.860***	1.392***	0.851***
ESCORE			0.0331	0.385
SSCORE			6.171***	4.303***
GSCORE			1.893*	1.842*
_cons	-15.75***	-7.405***	-15.68***	-7.413***
N	16,159	11,698	16,159	11,698
adj. RSq	0.41	0.20	0.41	0.21

Results

Panel 3 – Banks

	ROA_t	ROA_{t+1}	ROA_t	ROA_{t+1}
ESGSCORE	10.64***	12.53***		
lnTA	-0.295**	-0.599***	-0.319***	-0.606***
ESCORE			8.299***	5.350*
SSCORE			6.683*	8.560**
GSCORE			0.436	2.353
_cons	5.313***	10.41***	5.942***	10.51***
N	848	541	848	541
adj. RSq	0.22	0.70	0.37	0.75

Panel 4 – Insurance companies

	ROA_t	ROA_{t+1}	ROA_t	ROA_{t+1}
ESGSCORE	18.01**	16.95*		
lnTA	-0.296	-0.223	-0.308	-0.223
ESCORE			5.171	4.955
SSCORE			8.420	7.298
GSCORE			6.070*	5.804*
_cons	6.582*	5.209	6.625*	5.081
N	351	237	351	237
adj. RSq	0.27	0.19	0.23	0.11

Implications for policy takers

- ESG policies are positively related to profitability
- For industrial companies, the effect on profitability gradually slows during the years
- Growing concern for ESG within banks (and in particular Environmental issue)[1]
- Banks should continue to focus on risks and opportunities from implementing ESG practices to move to a sustainable business

[1] e.g., the top five U.S. banks in terms of market capitalization - JPMorgan Chase, Bank of America, Wells Fargo, Citigroup, and Morgan Stanley - have all adopted programs to steadily improve their environmental performance

Implications for policy makers

- Continue to support companies' ESG activities through the issue of socially responsible standards and principles
- Green Supporting Factor + ESG Supporting Factor/Brown Penalizing Factor

Shortcomings, current and further research

Shortcomings

- Endogeneity and causality
- Sample selection

Current and further research

- EU area
- Role of disclosure and reporting framework - taxonomy
- Extend the long term perspective
- Listed and Unlisted companies
- Different components of each ESG dimensions
- What about the companies funded by banks?

Brogi, M., & Lagasio, V. (2019). Environmental, social, and governance and company profitability: Are financial intermediaries different? *Corporate Social Responsibility and Environmental Management*, 26(3), 576-587.

Thank you for your attention!

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