ESG Disclosure As Advertisement of Corporate Bond Issuances

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"I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."

James Carville, political adviser of Bill Clinton

This paper investigates whether firms strategically deviate positively from their normal environmental, social, and governance (ESG) disclosure levels as a signal to investors to obtain better access to finance. Analysing 3,900 firm-year observations in the US corporate bond market from 2009 to 2017, we find this signal across all three ESG dimensions for firms facing high refinancing risk that issue a bond. Moreover, we find that firms that issue a bond have generally higher ESG disclosure levels than firms that do not. We further confirm our hypothesis by empirically proving that financial benefits in terms of lower bond spreads are realised after this increased ESG disclosure signal. We additionally demonstrate that the ESG performance of the issuing firm increases.

Research Question: Do firms utilise ESG disclosure strategically to obtain preferred financing conditions when raising bond capital on primary markets?

Theory: Signaling Theory (Spence, 1973)

- Voluntary Disclosure: ESG disclosure framed as a form of advertising, as an "*active*" rather than "*passive*" signal (Lys et al., 2015)
- *Literature*: Firms with better ESG disclosure rely more on public debt than bank debt (Tan et al. 2020)

In anticipation of issuing a bond…

H1 **… firms show higher levels of expected ESG disclosure** ✓

H2 **… firms deviate from the expected ESG disclosure levels** ✖

H3 **… firms with high refinancing risk deviate from their expected levels of ESG disclosure** ✓

Model: Non-binary measurement of disclosure: Split BBG ESG disclosure score into two components (Lys et al. 2015):

1. Component explained by firm characteristics (Normal ESG = fitted value, H1)
2. Unrelated component (ESG Deviation, H2&H3)

$$ESG_{i,t} = \beta_0 + \beta_1 Sales_{i,t} + \beta_2 Income_{i,t} + \beta_3 CF_{i,t} + \beta_4 Leverage_{i,t} + \beta_5 MTB_{i,t} + \beta_6 Advertising_{i,t} + \beta_7 Litigation_{i,t} + Ind_{FE} + \varepsilon_{i,t}$$

$$\begin{aligned} Normal\ ESG_{i,t}\ OR\ ESG\ Deviation_{i,t} &= \beta_0 + \beta_1 Bond\ Decision_{i,t-1} + \beta_2 Refinancing\ Risk_{i,t} \\ &+ \beta_3 Refinancing\ Risk_{i,t} * Bond\ Decision_{i,t-1} \\ &+ \beta_4 Financial\ Constraints_{i,t} + \beta_5 Debt\ Level_{i,t} + \beta_6 Amount\ Issued_{i,t} \\ &+ \beta_7 Size_{i,t} + Ind_{FE} + \varepsilon_{i,t} \end{aligned}$$

Variables	**Normal ESG**	**ESG Deviation**
Bond Decision (Y/N)	1.179***	0.319
Refinancing Risk	0.645	-0.177
Bond Decision x Refinancing Risk	-2.076	7.758**
Financial Constraints	-3.191**	-14.20***
Debt Level	-0.587	1.005**
Amount Issued	-0.0176	-0.0104
Size	6.374***	-1.002***
Constant	-52.83***	-38.80***
Observations	3,900	3,900
R squared	0.771	0.016
Industry FE	Y	Y
Cluster	Firm-Year	Firm-Year

Additional analyses:

Signal across all **3 dimensions of ESG**: Strongest for the environmental and social dimensions in line with previous literature.

Bond spreads: Positive effect on the cost of debt that previous literature notes for ESG disclosure.

Greenwashing debate: Increased ESG disclosure correlates with improved ESG performance.