Building Social Capital and Trust in Corporations:

The Role of Corporate Social Responsibility

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Social Capital

General perspective:

- What is social capital?
- What is the (macro)economic impact of social capital?

Corporate perspective:

- How can corporations build their social capital?
- Do those investments pay off?
- What prevents companies from investing optimally in social capital?

Social Capital: Definition and Components

- Broad concept – different authors provide different definitions

- Putnam: "*The propensity of people in a society to cooperate to produce socially efficient outcomes*"
  - Social networks, reciprocity, trust

- Coleman: "*A resource available to individuals that emerges from social ties*"

Social Capital: Definition and Components (cont.)

Common components:

i. *Networks*

ii. *Ease of cooperation – reciprocity*: "I will be good to you because I believe you will be good to me at some point in the future"

iii. *Trust*: "Expectation that another person (or institution) will perform actions that are beneficial to us regardless of our capacity to monitor those actions"

Social capital builds trust and cooperation (and vice versa)

Early Work: Social Capital and Economic Outcomes

- Initial focus on society as a whole or on various regions within countries

- Most common proxies:
  - Civic engagement
  - Willingness to trust people

- Social capital is <u>related</u> to many economic outcomes:
  - GDP growth
  - Financial development (stock market size, company size)
  - Lack of corruption
  - …

Recent Work: Social Capital and Corporate Policies

- Trust is defined at geographic level
- Firms in high trust regions have:
  - Fewer agency problems
  - Higher valuations and profitability
- Firms in low trust regions:
  - Pay more dividends
  - High-dividend paying firms trade at a premium in low trust regions compared to low-dividend paying firms
- ***"Endowed trust"*** – trust a firm inherits due to its location

Social Capital at the Firm Level: Organisational Social Capital

- ***"Earned trust"*** – trust a firm builds through its investments in social capital

- Social capital: A resource reflecting the quality of the relations between a firm and its stakeholders

- A firm's investment in social capital:
  - Engenders cooperation and trust from its stakeholders,
  - Alleviates moral hazard and adverse selection

  which, in turn, can result in positive economic outcomes for the firm.

How to Build Social Capital?

- Social ties
  - Managerial ties
  - Social capital of individuals in an organisation – workers, etc.

- ***Corporate social responsibility investments***

CSR as a Measure of Social Capital

Corporate social responsibility:

"CSR is the commitment of a business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve the quality of life."

[World Business Council for Sustainable Development]

Academic work: A firm's <u>corporate social responsibility</u> (CSR) activities as an observable measure of a firm's social capital (Sacconi and Degli Antoni 2011).

CSR as a Measure of Social Capital: Practitioners' View

pwc Global

17th Annual Global CEO Survey: Building trust

17th Annual Global CEO Survey

Building trust

The world in which we live and work is being redefined by fundamental global trends. The impact of these trends is radically changing society's expectations of business. The extent to which a business behaves in line with these expectations determines how trustworthy it's perceived to be. This is putting trust high up on the CEO agenda. While the 'trust deficit' has narrowed, lack of trust in business is still a major concern for business leaders. Our survey identifies three strategic priorities for CEOs wanting to build trust in business.

Evaluating CSR activities

- Whose perspective? Society? Individuals? Firms?
- Research in economics, finance and accounting takes the perspective of Friedman (1970):

  "*The social responsibility of a business is to increase its profits*"
- Thus, attention is on ***whether CSR activities create value for shareholders***

Does Social Capital Built Through CSR Activities Pay Off?

- Evidence is mixed, although more work suggests a ***positive relation*** between CSR activities and firm value.

- Problems/Challenges:
  1. How is value created? Model?
  2. Measurement, choice of metric:
     - Returns, market value, accounting performance?
     - CSR expenditures or CSR efforts/outcomes?
  3. What do we learn? Inferences about ***causality***?

LSE

How Is Value Created?
Model Specification

Direct or Indirect Effect?

CSR activities → Firm value?

CSR activities → Consumer Behaviour → Firm value?

CSR activities → Employee Behaviour → Firm value?

CSR activities → Politicians' Behaviour → Firm value?

Most studies focus on the direct link between firm value and CSR even though the effect is likely to be indirect.

How Is Value Created? Model Specification (cont.)

Econometric Model

$$\mathit{Firm\ Value}_{i,t} = b_1 + b_2\, \mathit{CSR}_{i,t} + B_3\, \mathit{controls}_{i,t} + e_{i,t}$$

- Panel data estimation

How to Measure Value?
Choice of Performance Metric

- Depends on your ***beliefs on market efficiency***

- If the market is ***(semi-strong) efficient:***
  - Cannot use returns: value of CSR is already reflected in prices, unless new information becomes available
  - Could use other metrics (Tobin's q, ROE, ROA…) but usually just suggestive of an association

- If the market is ***(semi-strong) inefficient:***
  - Focus on excess/abnormal returns
  - The assumption is that stocks are mispriced and that the mispricing is corrected subsequently
  - Other metrics also helpful (Tobin's q, ROE, ROA…)

How to Measure CSR Activities?
Choice of CSR Metric

- CSR expenditures or CSR efforts/outcomes?
- CSR expenditures: no data available and not all the CSR activities involve a monetary cost
- CSR efforts/outcomes:
  - Several providers of data on ESG attributes of firms (MSCI ESG; ASSET 4 ESG; Bloomberg ESG)
  - Provide 0/1 indicators reflecting the strengths and weaknesses of a firm's CSR performance in a given item
  - Various categories: Community, employment, human rights, diversity, environment, product, governance…

What Do We Learn? Inferences

- Academic evidence suggestive of a ***positive relation between CSR and firm value***
- ***Can we conclude that CSR activities create value?***
- ***Not necessarily.*** We need to consider whether:
  - Other factors driving the relation? *Omitted variables*
  - Are we “Doing well by doing good” or “doing good by doing well”? *Reverse causality*
  - Generalizability and extrapolation?

Inferences:
Correlation or Causality?

Omitted factors

- We estimate:

CSR activities → Firm value

- But the true model could be, for example:

CSR activities   Firm value

Another variable (e.g. Profitability)

Inferences:
Correlation or Causality? (cont.)

Causality

CSR activities ⇄ Firm value

- To address this problem, we would like to observe changes in CSR unrelated to firm policies and characteristics (***exogenous shock***) and examine if those changes drive changes in firm value

- Not easy to find such shocks!

In Our Research…

… We have tried to address these problems by:

- ***Consumer channel*** as a mediator

- Exploiting an ***external (exogenous) shock to generalized trust*** (financial crisis) and examining whether firms that have built social capital/trust through CSR activities perform better when trust unexpectedly declines and becomes more valuable

The Impact of Corporate Social Responsibility on Firm Value: The Role of Customer Awareness

Henri Servaes
London Business School

Ane Tamayo
London School of Economics

Management Science, 2013

What We Do

- Challenge the idea that CSR affects directly firm value
- Explore one of the channels through which CSR can add value: consumer channel
- ***Our hypothesis***: CSR can only be valued by a firm's customers if there is ***customer awareness*** of such activities
- Employ advertising intensity to measure awareness

Findings and Interpretation

- No direct relation between value and CSR once firm characteristics are controlled for

- Positive relation between value and CSR interacted with advertising Information about the firm's CSR activities needs to be in the public domain for them to pay off

- The positive relation between CSR and value is stronger for firms at the top of Fortune's "Most Admired Firms List"; for firms at the bottom, relation reverses CSR efforts not in-line with a firm's prior reputation do not pay-off

Caveats

- Although we focus on CSR and value changes, we cannot fully establish causality

- Other channels (e.g., employee channel) may act as complements or substitutes of the consumer channel, reinforcing or offsetting the documented CSR-value relation

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Social Capital, Trust and Firm Performance: The Value of CSR during the Financial Crisis

Karl V. Lins
University of Utah

Henri Servaes
London Business School

Ane Tamayo
London School of Economics

Journal of Finance 77, 2017

What We Do

- Relate CSR to social capital and trust

- Try to establish causality: Focus on ***a period in which overall trust unexpectedly declined*** (financial crisis) but firm investment in CSR remained constant in the short run – exogenous to individual firms

- ***Our hypothesis***: If firms' CSR efforts help build social capital and trust, those efforts should pay-off more when trust is more valuable

- Focus on (abnormal) stock returns

Did Trust Decline During The Financial Crisis?

- *Edelman Trust barometer*: survey data showing trust in business in US declined from 58% in early 2008 to 38% in 2009

- *"The present financial crisis springs from a catastrophic collapse in confidence … Financial markets hinge on trust, and that <u>trust has eroded</u>."* (Stiglitz, 2008)

- *"The fundamental problem isn't lack of capital. It's <u>lack of trust</u>. And without trust, Wall Street might as well fold up its fancy tents."* (Reich - Former US Labour Secretary, 2008)

- *"The global financial and economic crisis has done a lot of <u>harm to the public trust</u> in the institutions, the principles and the concept itself of the market economy"* (Gurria – OECD Secretary, 2009)

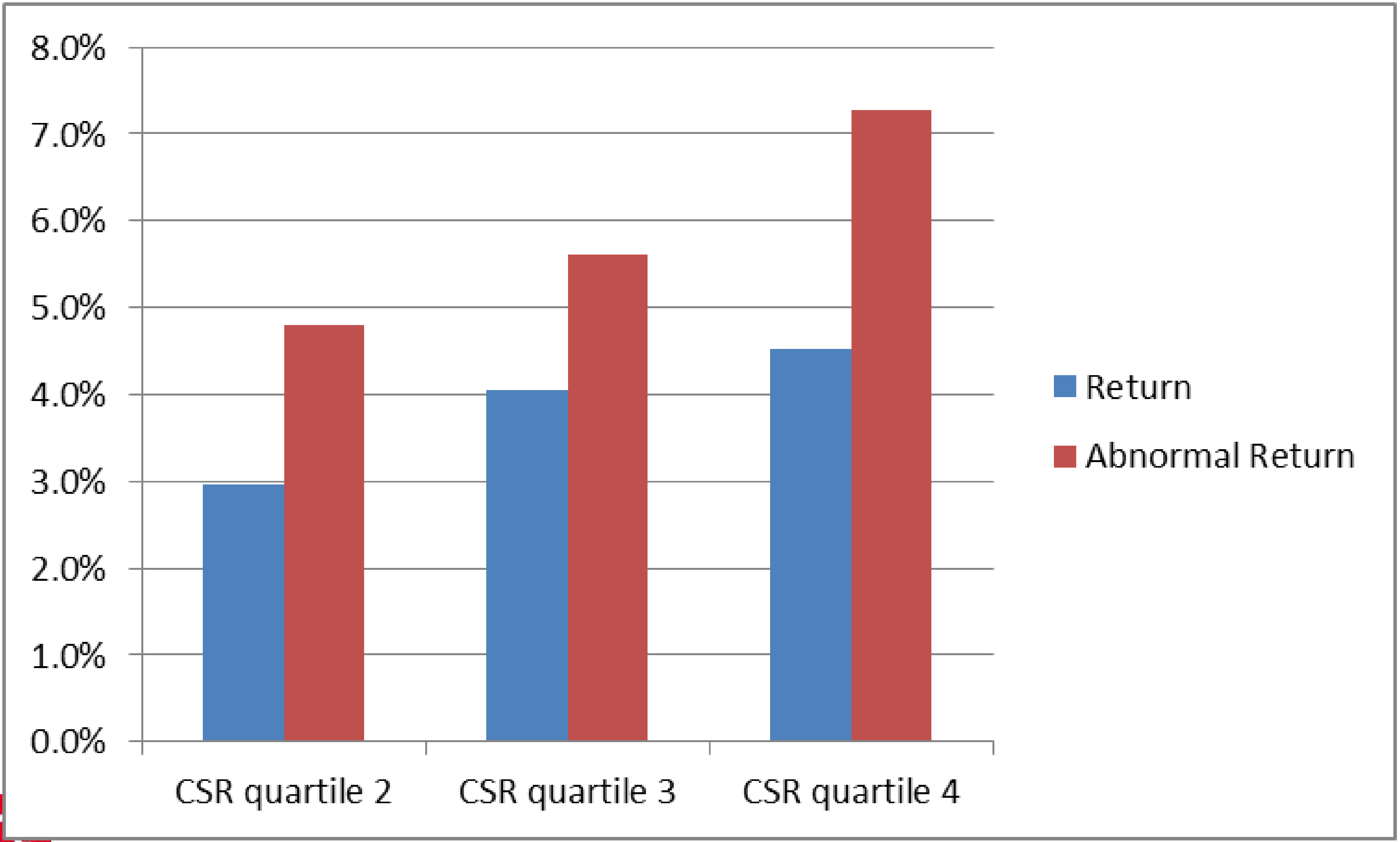
Crisis Period Returns and CSR

Did high-CSR firms perform better than low-CSR firms during the crisis period (August 2008-March 2009)?

Findings:

- High-CSR firms performed better than low-CSR firms over the crisis.
- Non-monotonic relation.

Crisis (Aug 08 – March 09) Return Differentials with Respect to Lowest CSR Quartile



Findings from Further Tests

- CSR does not affect returns before or after the crisis

- The CSR effect is stronger in high trust regions than low trust regions (endowed trust and earned trust are complementary)

- Similar effects if we focus on the period around Enron/Worldcom Fraud Scandals

CSR, Operating Performance and Capital Raising

What are the sources of the excess returns earned by high-CSR firms?

CSR, Operating Performance and Capital Raising – Quarterly Data

Effect of increasing CSR from its 25th to its 75th percentile

	Mean 2007-2013	Crisis Mean	CSR Effect in the Crisis	CSR Effect in the Post-Crisis
(1) Operating Return on Assets	3.10%	2.20%	+0.28%	+0.10%
(2) Gross Margin	40.10%	38.30%	+0.55%	+0.44%
(3) Sales Growth	3.24%	-6.91%	+2.33%	+0.45%
(4) Accounts Receivable / Sales	58.57%	59.16%	-0.17%	+0.22%
(5) Sales per Employee	$131,484	$116,990	+$13,413	+$6,836
(6) Debt Issuance / Assets	2.61%	2.26%	+0.17%	+0.10%
(7) Equity Issuance / Assets	0.34%	0.17%	-0.02%	-0.01%

The Bond Market Benefits of Corporate Social Capital

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What We Do

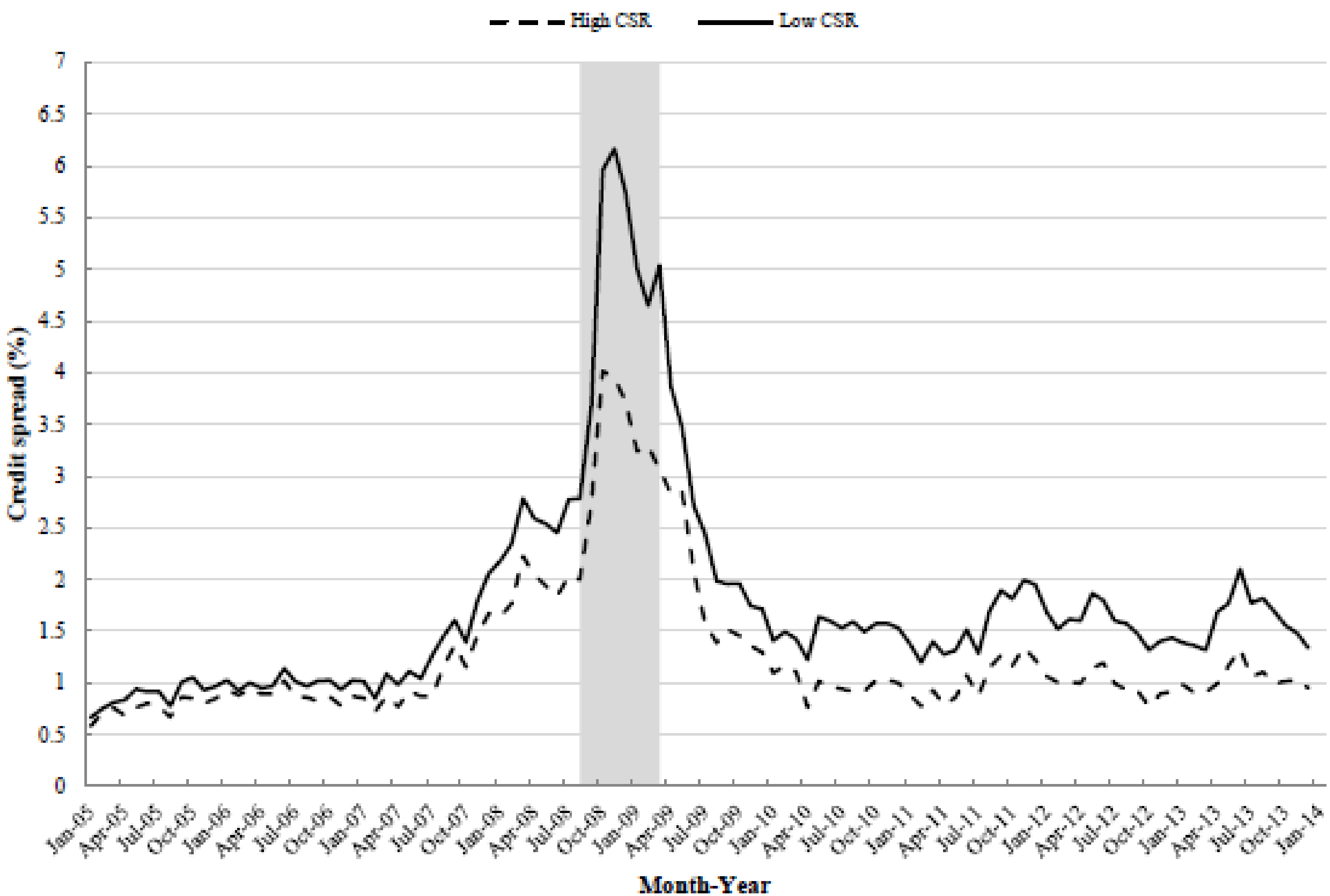
- Examine the importance of a firm's social capital investments through CSR activities on the bond market

- Why the bond market?
  - Size of the market
  - Moral hazard is of particular concern: risk shifting / cash diversion when companies are in financial distress

- ***Our hypothesis***: If firms' CSR efforts help build social capital and trust, those efforts should pay-off more when trust is more valuable

- Focus on bond spreads, access to the bond market and terms of contracts

The Results in One Slide



Cross-Sectional Differences and Interpretation

- Effects are stronger for firms with more opportunities for risk shifting and asset diversion
  - Firms with more debt
  - Firms with more intangible assets (low tangibility)
  - Firms incorporated in states without restrictions on dividend payments in distress

- Interpretation: Firms CSR activities reduce the perception of agency costs when generalised trust is low

Primary Market Effects

During the crisis period, high CSR firms:

- Have greater access to the bond market
- Are able to borrow more cheaply (given their risk)
- Are able to issue bonds with longer maturities
- Obtain relatively better credit ratings

Conclusions from Our Research

- CSR activities can increase firm value by engendering trust and cooperation
- Effect is not direct but indirect through:
  - Consumer channel
  - Employee channel
- CSR activities may be costly activities for some firms (e.g. if the firm reputation is at odds with its CSR activities)

Given the Benefits, Why Do Not All Firms Engage in CSR Activities?

- Capital constrained: unlikely

- Lack of information on the part of companies:
  - Possible, but should dissipate over time as merits of building social capital become known

- Lack of information on the part of investors:
  - Investors do not understand the merits, so they are not immediately incorporated in stock prices. As benefits materialize, performance is better than expected, yielding excess stock returns
  - This effect should also dissipate over time (as investors learn and firms communicate more effectively)

Given the Benefits, Why Do Not All Firms Engage in CSR Activities? (cont.)

- Lack of information across various stakeholders:
  - If one group of stakeholders rewards the firm for treating another group of stakeholders better, then they need to be aware of this
  - E.g. customers cannot be reward firms for being good to employees if the information is not available
  - Firms optimally refrain from engaging in CSR
  - Maybe the firm information environment matters

⇨ For some firms may not be optimal to invest in CSR

Given the Benefits, Why Do Not All Firms Engage in CSR Activities? (cont.)

- Lack of commitment from managers:
  - Market inefficiency, combined with poor incentives
    - If it is not reflected in market prices and has immediate payoffs, managers do not engage in CSR because they are not rewarded for long-run returns
    - Short-termism
  - Market for corporate control:
    - Firms do not feel they can take the long-term view, because they will be taken over

Is There Underinvestment in Social Capital?

- Firms investing substantial amounts
  - In 2013, firms in Fortune Global 500 spent $19.9 billion.
  - Largest spending: Oracle average annual spending $2.3bn (R&D spending: $4.8billion; Capital spending: $751m)

- Is this enough? Jury is still out

- Costs and benefits of social capital are not well understood
  - If all firms were to engage in high CSR levels, would they all reap the benefits? Or A “rat race” leading to overinvestment?
  - The cost and benefits are likely to vary across firms/industries

Final Thoughts

- Without social capital, payoffs to (tangible and intangible) capital investments are likely reduced

- Social capital builds trust, which in turn, improves cooperation within the firm with less need for formal (and surely incomplete) contracts

- CSR is currently the/our preferred metric to capture social capital at the firm level, but others should be explored

- Some arguments that firms may not be doing enough, but we urge caution and call for more research before making firm recommendations

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