Credit Derivatives and Corporate ESG Performance

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Abstract

Credit default swap (CDS) trading has a positive effect on the firm's ESG performance measured by ESG ratings. This effect is concentrated on ESG strengths rather than concerns. The proposed empirical connection remains valid with different endogeneity-controlling methodologies, model specifications, and ESG performance measures. We find the effect is more pronounced with firms that have stronger bank relations, higher debt dependence, and more restrictive covenants. Our findings reveal the real effects of credit derivative trading on firms' ESG performance and rating.

Keywords: Credit Default Swaps, ESG Performance, Debt Dependence

Introduction

In the past two decades, companies have significantly increased their awareness of and engagement in environmental, social, and governance (ESG). There is a trade-off between long-term reputation benefits and short-term expenditures of ESG investment. In the long run, prior literature shows that stronger ESG performance minimizes the chance of negative legal or regulatory events, builds a long-term relationship with various stakeholders, and provides reputation protection (Godfrey 2005; Benabou and Tirole 2010; Kim, Li, and Li 2014; Koh, Qian, and Wang 2014). Notably, most of those benefits will materialize in the long term. In the short run, the amount of spending on ESG projects sometimes can be significant enough to increase the cashflow burden and reduce the firm's short-term profitability (Chen, Hung, and Wang 2018; Masulis and Reza 2015). In line with this argument, Gao et al. (2021) find empirical evidence supporting that firm's strong social performance increases short-term credit risk although decreases long-term credit risk. Unlike shareholders, bondholders usually place greater focus on a firm's ability to fulfill its short-term debt obligations than its ESG performance which usually benefits shareholders in the long term.

As one of the most successful but controversial financial innovations, the credit default swap (CDS) provides insurance like credit risk protection on firms' outstanding debt. There are well-document real effects of CDS trading on the reference firm's underlying financial decision and outcome (Subrahmanyam, Tang, and Wang 2014; Li and Tang 2016; Subrahmanyam, Tang, and Wang 2017; Danis 2017; Danis and Gamba 2018; Chang et al. 2019). Besides, the CDS initiation alters the creditors' monitoring incentive and loan policies (Acharya and Johnson 2007; Shan, Tang, and Winton 2019; Shan et al. 2021). CDS trading is considered an exogenous shock on creditors' and borrowers' financial policies. Importantly, CDS protection potentially weakens the concavity of debtholder's payoff functions and alleviates debtholders' concerns over short-term increased risk

from ESG investing. The emergence of CDS trading may possibly curtail the incompatibility between debt financing and ESG investment. In this paper, we attempt to answer the question of whether the trading of such credit risk hedging instruments may halt bondholders' concern over ESG short-term increased risk. Whether the emergence of CDS trading increase lenders' risk tolerance toward ESG expenditures? Does CDS initiation eventually encourage firms' ESG activities?

Overall, our empirical evidence suggests that CDS trading has a positive connection with corporate ESG performance. The effect concentrates on the enhancement of ESG strengths rather than the relieving of the ESG concerns. Under the assumption of ESG strengths serve as a reasonable proxy for ESG spending, the results suggest that CDS initiation attenuates the tension between creditors and ESG spending. We design and implement a series of endogeneity checks, including placebo tests, propensity score matching, and instrumental variable analyses. The CDS trading effect remains valid and significant after the control of endogeneity controls.

Next, we explore the plausible mechanisms through which CDS trading would contribute to the improvement of corporate ESG performance. According to weakened lenders' monitoring incentive, we predict that the proposed effects are stronger for firms with more connected bank relations, stronger lenders' monitoring, and more restrictive loan covenant terms. We examine the potential asymmetry CDS trading effect using subsample analysis. Our empirical finding shows that the impact on ESG performance is more pronounced in firms with greater debt dependence or under more banks' monitoring, supporting the conjecture that CDS trading benefits the underlying firm by loosening bank monitoring and loan terms, which further enhances the corporate ESG ratings. Moreover, according to the expanded credit supply channel, we expect that the firms with low credit quality and worse solvency status benefit more from extra fund supply from lenders after CDS initiation. Specifically, we split the sample according to the firm's distance default, leverage ratio, and credit rating. Our findings fail to support the expanded credit supply channel. We find that the CDS impact on ESG performance is more concentrated on good-quality borrowers rather than on low credit quality firms.

The empirical findings of our work contribute to the literature twofold. First, we extend the understanding of the determinants of corporate ESG performance (Tang, Yan, and Yao, 2021). The established relation connects the financial hedging possibility with the corporate ESG decision. Second, the empirical evidence adds the analysis of the real effect of CDS trading on corporate policies. Our results support the channels of reduced bank monitoring incentives and their consequence on firms' ESG investments.