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ESG Factors and Financial Outcomes in Banks

Quantitative Insights into the ESG-Cost of Debt Relationship

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To my family…

Introduction

Sustainability has become a crucial issue for today's economy, with the financial sector at the forefront of this shift. The rising emphasis on environmental, social, and economic sustainability stems from a recognition that addressing these issues is not just a moral or environmental concern but essential for building long-term economic resilience and societal well-being (Clark et al., 2015). Recent years have seen intensified attention on phenomena like climate change, pollution, resource depletion, and social inequality, each posing direct threats to economies and communities. What were once considered abstract concepts are now material realities that demand immediate attention from governments, financial institutions, and market actors worldwide. This growing awareness has catalyzed a paradigm shift, where sustainability has become central to economic planning and corporate strategy, redefining the goals and scope of financial markets (Schoenmaker & Schramade, 2019).

The shift toward sustainability also requires a reassessment of traditional economic models, particularly with the integration of frameworks like ESG (Environmental, Social, and Governance) criteria. Since their introduction in the early 2000s, ESG factors have redefined what constitutes corporate success, shifting the focus from short-term financial gains to long-term stability and resilience (Eccles et al., 2014). ESG criteria have become essential in evaluating companies, moving beyond conventional financial metrics to include non-financial risks and opportunities that impact a company's performance, reputation, and viability. Companies embracing ESG are increasingly seen as forward-thinking, capable of mitigating risks associated with environmental degradation, social unrest, or governance failures. Research shows that ESG-oriented companies tend to exhibit stronger financial performance, resilience, and competitiveness (Friede et al., 2015), highlighting that sustainable practices are not just ethical but economically beneficial.

However, despite the growing prominence of ESG criteria, significant challenges remain, particularly regarding the standardization of ESG metrics. The lack of universally accepted definitions and measurement frameworks creates inconsistencies in how ESG performance is assessed, reported, and interpreted. These disparities complicate efforts to compare companies across industries or regions and may lead to issues like greenwashing, where firms exaggerate or misrepresent their sustainability efforts. For financial institutions and researchers, this lack of standardization poses a challenge in accurately integrating ESG considerations into risk assessments, investment decisions, and lending practices. Addressing these issues is critical to ensuring the credibility and effectiveness of ESG as a tool for driving sustainable transformation.

This book seeks to explore this transformative shift in both economic and cultural contexts, focusing on ESG's growing role in corporate finance and bank lending. The empirical analysis in this book investigates whether companies that actively engage in ESG practices experience reduced costs of debt financing, a question that has received limited attention in the literature, as most research has focused on the cost of equity or CSR impacts rather than debt financing (Goss & Roberts, 2011). This study fills this gap by examining whether banks perceive ESG-aligned companies as lower-risk borrowers, potentially rewarding them with more favorable loan terms. Such insights are crucial, as banks play a key role in capital allocation, influencing companies' access to financing and driving sustainable growth.

The central hypothesis of this research posits a negative relationship between ESG performance and the cost of debt, suggesting that companies committed to ESG may be perceived as less risky and receive more favorable borrowing terms. This aligns with a broader trend where financial markets increasingly recognize that sustainability is not only a corporate responsibility but also a strategic advantage that can mitigate risk and enhance long-term returns.

The book is organized into the following sections:

Chapter 1 explores the historical evolution of sustainability concepts and sustainable finance, from early ideas on corporate social responsibility (CSR) to the rise of ESG criteria. This chapter reviews key management theories, such as stakeholder theory and shared value creation, which have underpinned the shift towards sustainable practices. It also examines the significant role of banks in promoting ESG initiatives by embedding sustainability into their lending strategies.
Chapter 2 delves into the regulatory landscape shaping sustainable finance, particularly in the European Union. It highlights major initiatives like the European Green Deal, the Sustainable Finance Disclosure Regulation (SFDR), and the EU Taxonomy for sustainable finance. This chapter emphasizes the role of regulation in guiding financial markets toward sustainable practices, setting the foundation for future policy shifts aligned with environmental, social, and governance goals. By examining these frameworks, the chapter illustrates how regulatory advancements aim to create a cohesive approach to sustainability across financial markets.
Chapter 3 presents the book's empirical analysis, focusing on data from 107 European companies between 2017 and 2021. The analysis investigates the potential link between a company's ESG performance and its cost of debt, testing the hypothesis that banks may offer more favorable lending rates to ESG-aligned companies. The chapter also contextualizes these findings within the EU's broader commitment to sustainability, providing insights into how banks might leverage ESG considerations to foster responsible corporate behavior and create financial incentives for sustainability.
Chapter 4 Future Directions and Innovations in Sustainable Finance: Challenges and Opportunities looks ahead to the future of sustainable finance, discussing emerging trends, technological innovations, and unresolved challenges in ESG integration. This chapter examines the role of artificial intelligence, blockchain, and other digital tools in improving ESG transparency and standardization, as well as the potential for these technologies to address greenwashing concerns. It also highlights the need for global harmonization of ESG metrics and explores innovative financing mechanisms, such as green bonds and sustainability-linked loans, that could drive further progress in aligning financial markets with sustainability goals. In summary, this book contributes to the growing body of literature on sustainable finance by exploring how ESG factors influence corporate financing,

particularly regarding the cost of debt. By examining the interplay between ESG and the financial sector, the book highlights the evolving role of banks in driving the transition to a sustainable economy. The findings underscore the significance of regulatory progress, ESG integration in investment and lending practices, and the financial sector's capacity to support sustainable development through responsible capital allocation. This work ultimately reflects the broader economic transformation underway as finance moves to support a resilient, inclusive, and sustainable future.

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CHAPTER 1

The Evolution of Sustainability: From CSR to Sustainable Finance

Abstract This chapter traces the evolution of sustainable finance, from early theories like the Malthusian trap to modern frameworks such as the Brundtland Report and the UN's 2030 Agenda. Key milestones, including the Stockholm Conference and The Limits to Growth report, highlight the tension between economic growth and resource limitations. The chapter examines global progress using tools like the Environmental Performance Index (EPI) and initiatives such as the European Green Deal. It emphasizes the critical need for coordinated actions to balance environmental, social, and economic dimensions for a sustainable future.

Keywords Sustainable finance · Environmental sustainability · Malthusian trap · Brundtland Report · Environmental Performance Index (EPI)

The Evolution of Sustainable Finance

The growing focus on sustainability-related issues has become increasingly pressing, as challenges like climate change, pollution, ozone depletion, deforestation, and resource degradation pose urgent threats to the planet's future (Rockström et al., 2009). The increasing awareness of these issues and the need for sustainable action reflect a journey

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