Building Trust and Social Capital in Corporations: The Role of ESG and Related Disclosures

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Introduction

Since the 2008 Financial Crisis, building trust has been at the forefront of the agenda of corporations and institutions

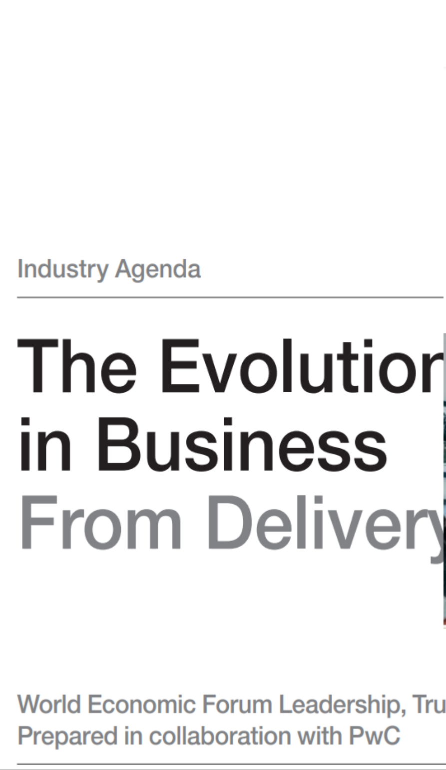

pwc Global

17th Annual Global CEO Survey: Building trust

17th Annual Global CEO Survey

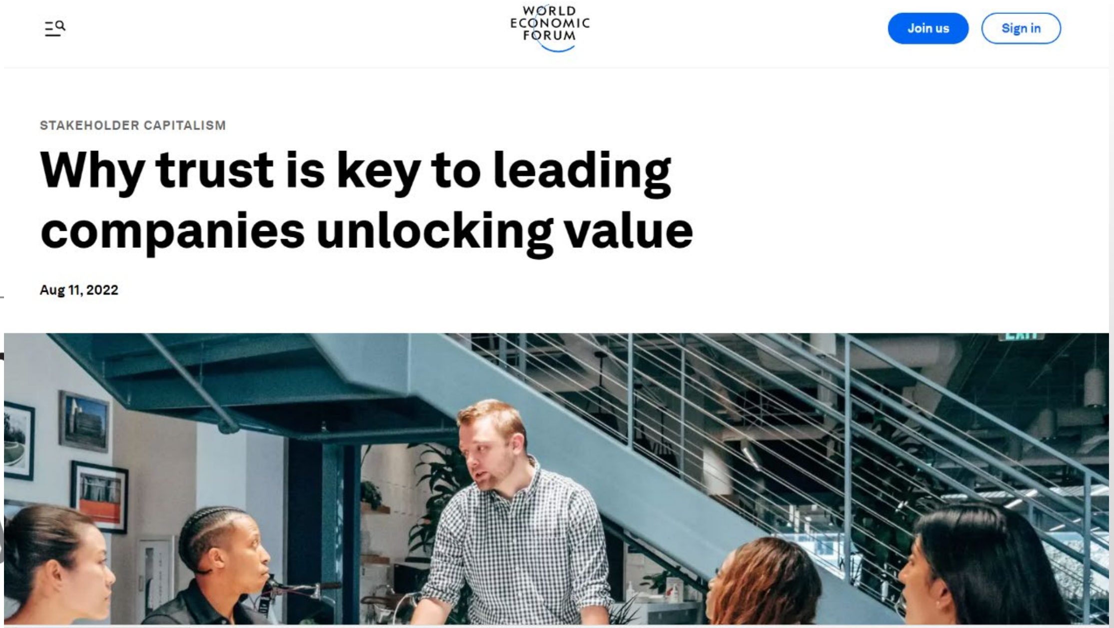
Building trust

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.


Industry Agenda

The Evolution
in Business
From Delivery

World Economic Forum Leadership, Trust and Performance Equation Project
Prepared in collaboration with PwC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STAKEHOLDER CAPITALISM

Why trust is key to leading companies unlocking value

Aug 11, 2022

Introduction (cont.)

- Why is trust so important for corporations?
- How do we build trust?
- Does it “pay off”?
- How do we build trust in an era of mis/disinformation?

Definition of Trust

- ***Trust***: "*the expectation that another person will perform actions that are beneficial, or at least not detrimental, to us regardless of our capacity to monitor those actions*." (Gambetta, 1988; Sapienza and Zingales, 2012)

- One way to build trust is by building social capital

Definitions of Social Capital

- Putnam (1993, 1995, 2000): Social capital is "*the propensity of people in a society to cooperate to produce socially efficient outcomes*"; "*The features … such as networks, norms, and social trust that facilitate coordination and cooperation for mutual benefit*"

- Common components (Paldam, 2000):
  i. Trust
  ii. Ease of cooperation/reciprocity
  iii. Networks

Why Is Trust so Important for Society?

- Trust is the "*lubricant of social life*" (Putman, 1993)

- Social capital, and the trust it engenders, is related to social and economic outcomes:
  - GDP growth
  - Financial development (stock market size, stock market participation,…)
  - Institutional development
  - Crime
  - Corruption
  - …

Why Is Trust so Important for Corporations?

- "*Virtually every commercial transaction has within itself an element of trust*." (Arrow, 1972)

- Firms as a nexus of contracts (Jensen and Meckling, 1976)

- Trust is particularly important when contracts are incomplete and monitoring is difficult

- Trust facilitates contracting and, as such, it can lead to positive economic outcomes for the firm

Evidence on Importance of Trust for Corporations

- Trust is defined at geographic level

- Firms in high trust regions have:
  - Higher valuations and profitability
  - Less earnings management; less tax avoidance
  - Better access to financing
  - Pay lower dividends
  - More innovation
  - Fewer agency problems

- ***"Endowed trust***" - trust a firm "acquires externally" from being located in a high/low trust region (Amiraslani, Lins, Servaes and Tamayo, 2023)

Earned Trust through Investments in Social Capital

- A firm can also build trust internally through its investments in social capital - ***Earned trust*** (Amiraslani, et al. 2023)

- Investments in social capital:
  - Engender cooperation and trust from stakeholders
  - Alleviate moral hazard and adverse selection

- Social capital: An "asset" reflecting the quality of the relations between a firm and its stakeholders

- ***How do we acquire/build this asset?***

How to Build Trust and Social Capital?

- Networks
  - Social ties: Social capital of individuals in an organisation (managers, employees, etc.)
  - Suppliers and customer networks

- ***CSR/ESG investments*** (Sacconi and Degli Antoni 2011)

ESG Investments to Build Trust and Social Capital

- ***ESG as a trust building tool:***
  - A firm that invests to ensure strong relationships with stakeholders is likely to be viewed as more trustworthy by stakeholders

- ***ESG as a reciprocity building tool:***
  - Stakeholders are more likely to “do whatever it takes” to help a firm that has been “good” to them in the past

ESG Investments to Build Trust and Social Capital

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CEOs share their insights on building trust in PwC's 17th Annual Global CEO Survey

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Evaluating ESG Activities

- Most common perspective has been on ***whether ESG activities create value for shareholders***

- Alternative perspective: companies engage in ESG to benefit society as a whole even if doing so may decrease shareholder value

- Different objective functions:
  - – Maximise shareholder wealth?
  - – Maximise shareholder utility/welfare?
  - – Maximise stakeholders' welfare?
  - – Maximise social welfare?

ESG and Shareholder Value

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

- Problems/Challenges:
  1. How is value created? The “story” - model
  2. How to measure ESG performance and value?
     - ESG expenditures/efforts or ESG outcomes?
     - Returns, market value, accounting performance?
  3. What do we learn?
     - Can we draw causal inferences?

In Our Research…

… We have tried to address these problems by:

- Exploiting ***exogenous shocks that <u>change the importance</u> that stakeholders may assign to ESG*** and examine if those changes drive changes in firm value
- Focus on stock returns and bond spreads around the events (new information)
- Use several metrics capturing ESG attributes of firms from providers of data (MSCI ESG; ASSET 4 ESG)

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

KARL V. LINS, HENRI SERVAES, and ANE TAMAYO*

ABSTRACT

During the 2008–2009 financial crisis, firms with high social capital, as measured by corporate social responsibility (CSR) intensity, had stock returns that were four to seven percentage points higher than firms with low social capital. High-CSR firms also experienced higher profitability, growth, and sales per employee relative to low-CSR firms, and they raised more debt. This evidence suggests that the trust between a firm and both its stakeholders and investors, built through investments in social capital, pays off when the overall level of trust in corporations and markets suffers a negative shock.

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What We Do

- Relate CSR/ES(G) to social capital and trust
- ***Our hypothesis***: If a firm's ESG efforts help build social capital and trust, those efforts should pay-off more when trust is more valuable
- Try to establish causality: Focus on ***a period in which overall trust unexpectedly declined*** (financial crisis) but firm investment in ESG remained constant in the short run – exogenous to individual firms
- ***Did firm investments in social capital and trust (ESG) pay off during financial crisis?***

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 trust has eroded."* (Stiglitz, 2008)

- *"The fundamental problem isn't lack of capital. It's lack of trust. 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 harm to the public trust in the institutions, the principles and the concept itself of the market economy"* (Gurria – OECD Secretary, 2009)

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Did Trust Decline During The Financial Crisis?

- *"Something important was destroyed in the last few months of 2008. It is an asset crucial to production, even if it is not made of brick and mortar… This asset is trust."* (Sapienza and Zingales, 2013)

Did this "asset" pay off during this crisis of trust?

Our Analysis

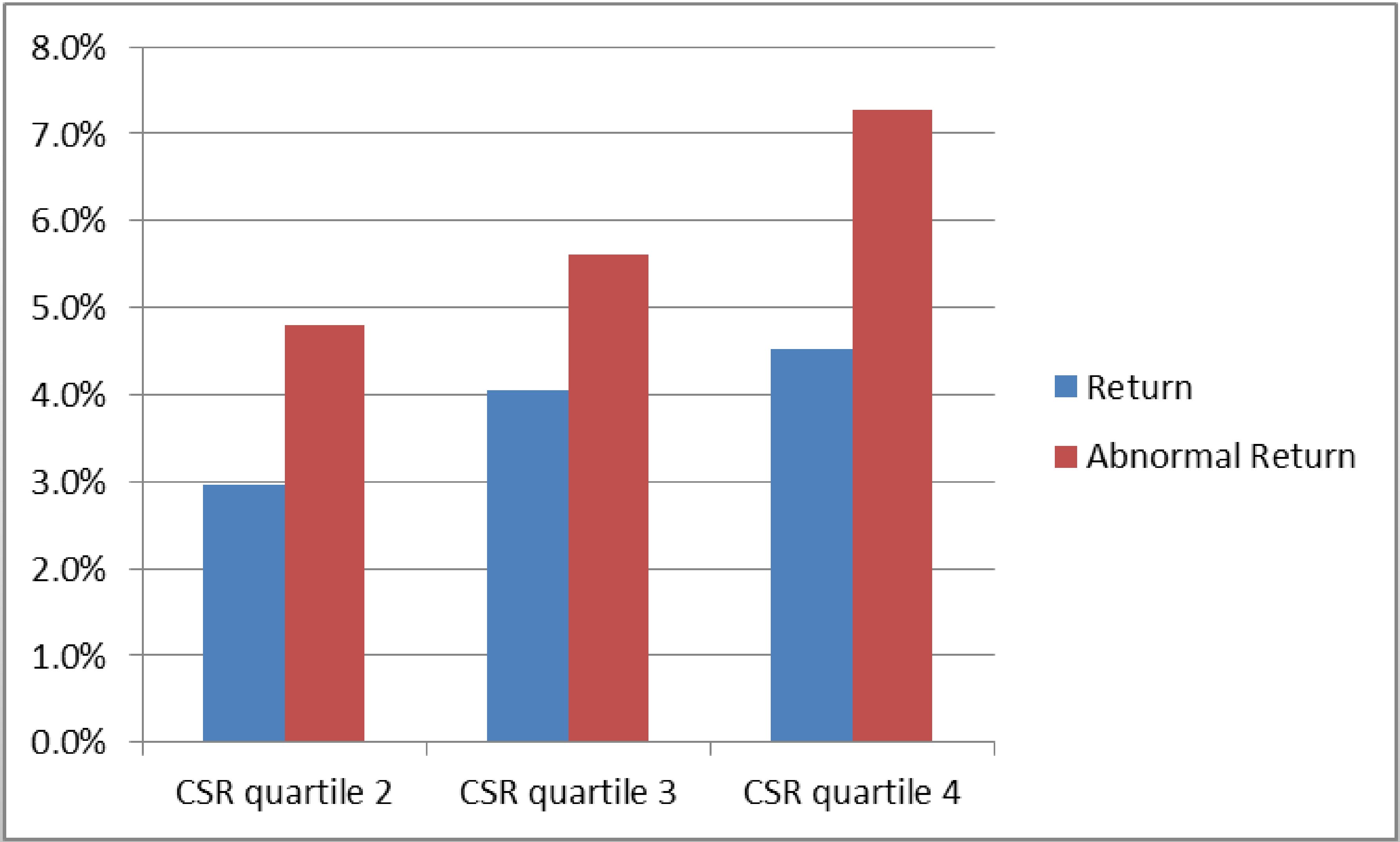
- Focus on the part of the financial crisis when trust declined Crisis period: August 2008-March 2009 (Sapienza and Zingales, 2012)

- Compare (abnormal) returns of high/low ES (control for G) firms before, during and after the crisis

- 1,673 US firms covered by MSCI ESG Stats over 2007-2013

The Results in One Slide

Crisis Return Differentials With Respect to Lowest ES Quartile



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Is This about Trust?

$$Return_{i,t} = b_o + b_1 CSR_{i,2006} \times Crisis_t + b_2 CSR_{i,2006} \times Post\text{-}Crisis_t + b_3{}'\mathbf{X}_{i,t-1}$$
$$+ Time\ Dummies + Firm\ Fixed\ Effects + e_{i,t},$$

- ES does not affect returns before or after the crisis
- Shock to credit period, July 2007-July 2008 - No ES-return relation
- ES effect is stronger in high trust regions than low trust regions (endowed trust and earned trust are complementary)

ESG, Operating Performance and Capital Raising

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

Effect of increasing ESG 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%

Review of Accounting Studies

Trust, social capital, and the bond market benefits of ESG performance

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Abstract
We investigate whether a firm's social capital and the trust that it engenders are viewed favorably by bondholders. Using firms' environmental and social (E&S) performance to proxy for social capital, we find no relation between social capital and bond spreads over the period 2006–2019. However, during the 2008–2009 financial crisis, which represents a shock to trust and default risk, high-social-capital firms benefited from lower bond spreads. These effects are stronger for firms with higher expected agency costs of debt and firms whose E&S efforts are more salient. During the crisis, high-social-capital firms were also able to raise more debt, at lower spreads, and for longer maturities. We find no evidence that the governance element of ESG is related to bond spreads. The gap between E&S performance of firms in the bottom and top E&S terciles has narrowed since the financial crisis, especially in the year prior to accessing the bond market.

Keywords ESG · CSR · Sustainability · Social capital · Trust · Corporate bonds · Bond spreads · Agency costs of debt · Financial crisis

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What We Do

- Examine the importance of a firm's social capital investments in the bond market

- Why the bond market?
  - Moral hazard is of particular concern: risk shifting / cash diversion when companies are in financial distress
  - Bond investors are more subject to agency costs of debt than loan investors - Lower ability to monitor, higher information costs, difficulties in recontracting

- ***Our hypothesis***: If firms' ES 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

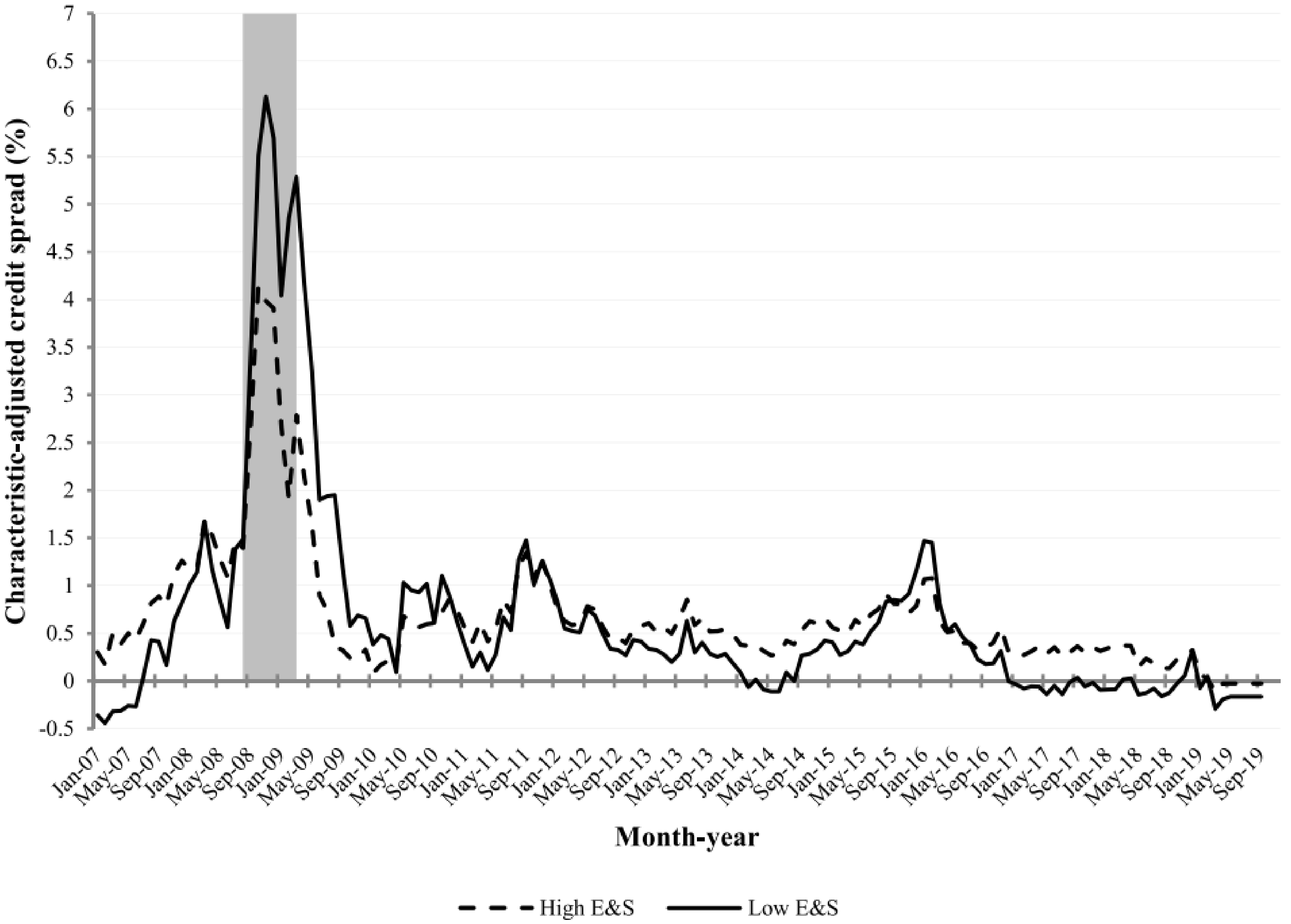

Fig. 1 Characteristic-adjusted secondary market credit spreads (2007–2019) for high- and low-E&S firms. To

Additional Analyses

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

- Effects are stronger when ES activities are more salient – firms with ESG reports

- Primary market analyses: firms with higher ES benefit from lower spreads, better credit ratings and longer bond maturities

So far…

- Firm investments in ES pay off when trust is low:
  - Higher returns
  - Lower bond spreads
  - Better access to debt markets – more borrowing, longer maturities, at lower cost
  - Effects more pronounced for firms with ESG reports

- ES investments have real effects when trust is low:
  - Cash flow effects
  - Discount rate effect?

Discount Rate Effects

- Traditional asset pricing models: focus on risk-return trade off

- Recent asset pricing models: incorporate investor preferences towards sustainability:
  - Investors are willing to accept a lower return to invest in high ESG firms
  - But when there is a positive shock to the "ESG factor", high ESG firms have positive abnormal returns

forthcoming , Journal of Accounting Research

Sexism, Culture, and Firm Value: Evidence from the Harvey Weinstein Scandal and the #MeToo Movement

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What We Do

- Do equity investors respond to changes in societal attitudes towards women?
- To draw causality: exploit the public revelation of the sexual harassment allegations against Harvey Weinstein and the subsequent resurgence of the #MeToo movement
- ***Our hypothesis***: as a result of this shock, investors re-evaluated the importance of having a non-sexist culture, shifting their preferences towards non-sexist firms
- ***Did firms with female leaders perform better than firms without female leaders around this time? Did investors switch their preferences/allocations?***
- Focus on abnormal returns, institutional ownership and changes in diversity metrics

The Results in One Slide

- Market values a "non-sexist" culture: return differential between firms w/ and w/o female leaders around the events is 1.3%

- After the events:
  - Institutional investor ownership in firms with female leaders increases
  - This increase is driven by investors with lower ESG preferences prior the event
  - Investors are actively rebalancing their portfolios towards less sexist firms
  - Firms cater to investor preferences by increasing diversity

- No driven by cash flow effects or increased litigation risk

- Results are most consistent with changes in investor preferences

In Sum

- Evidence that some ES activities pay off, at least during some periods (e.g., financial crisis, Covid)

- Cash flow effects but changes in investor preferences also seem to play a role

- Challenges in extrapolating the results:
  - Do these results hold in other countries, institutional settings…?
  - If all firms were to engage in high ES levels, would they all reap benefits? Convergence in ES performance

Table 11 Change in E&S performance over time

	E&S index	
	(1)	(2)
Low E&S index	−33.030***	−33.704***
	(1.811)	(1.846)
Low E&S index × 2008	3.486**	3.275*
	(1.711)	(1.719)
Low E&S index × 2009	3.700**	3.736**
	(1.887)	(1.937)
Low E&S index × 2010	3.885*	3.521*
	(2.032)	(2.114)
Low E&S index × 2011	4.466**	3.889*
	(2.176)	(2.192)
Low E&S index × 2012	6.322***	6.195***
	(2.229)	(2.256)
Low E&S index × 2013	5.959***	5.064**
	(2.227)	(2.299)
Low E&S index × 2014	6.817***	6.522***
	(2.236)	(2.275)
Low E&S index × 2015	7.361***	7.071***
	(2.204)	(2.251)
Low E&S index × 2016	8.323***	7.959***
	(2.202)	(2.230)
Low E&S index × 2017	9.912***	9.686***
	(2.188)	(2.237)
Low E&S index × 2018	10.222***	9.494***
	(2.289)	(2.320)
Low E&S index × 2019	10.887***	10.467***
	(2.315)	(2.333)
$Issue_{t+1}$		1.301
		(1.208)
Low E&S index × $Issue_{t+1}$		3.333***
		(1.655)
Time fixed effects	Yes	Yes
R-squared	0.419	0.425
Observations	4,255	4,255

Why Do Not All Firms Engage in ESG Activities?

- For some firms may not be optimal to invest in ESG – e.g. payoffs may be lower or costs too high; capital constrained; investors may not care…

- Managers do not understand the benefits

- Investors do not understand the payoffs; hence, prices don't fully reflect the benefits, at least in the short run

- Lack of information about the ESG activities – Shareholders and investors cannot reward firms for "doing good"

- ***Information and disclosure are important***

Importance of Disclosure

- Disclosure plays a pivotal role in capital allocation decisions – this should apply to ESG disclosures as well

- Problem: ESG investments are often intangible and difficult to verify – leaves room for cheap talk, untruthful disclosures, "***Greenwashing***"

- Substantial evidence of greenwashing – from firms, mutual funds… (ssrn search "Greenwashing": 450 papers 6/6/24)

- In an era of misinformation and disinformation, can we trust firms' ESG disclosures?

- ***How can firms/regulators build trust in firm ESG activities?***

Importance of Disclosure (cont.)

- Mandatory disclosure – assuming proper enforcement, this should alleviate greenwashing, but:
  - Trade-offs: monetary costs; proprietary costs…
  - Scope: Extent of the disclosures?
  - Reach: Some/all industries?; Public/private firms?; Some regions/worldwide?
  - Strike the “right equilibrium”: When do we go too far?

- Enforcement – Who should enforce these rules? What is the role of auditors?

- What is the role of other regulators: consumer protection, labour and human rights?

- What is the role of the market - institutional (active) investors?

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Some Final Thoughts

- Corporations can build trust through their investments in social capital/ES(G)

- Social capital is important:
  - Facilitates cooperation and contracting
  - Without it, payoffs to capital investments are likely reduced

- But greenwashing can lead to mistrust in ESG activities – market forces (e.g., investor voice) and regulation could play pivotal roles in alleviating this

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Table II.

Correlations between ESG ratings

Correlations between ESG ratings at the aggregate rating level (ESG) and at the level of the environmental dimension (E), the social dimension (S), and the governance dimension (G) using the common sample. The results are similar using pairwise common samples based on the full sample. SA, SP, MO, RE, KL, and MS are short for Sustainalytics, S&P Global, Moody's ESG, Refinitiv, KLD, and MSCI, respectively.

	KL SA	KL MO	KL SP	KL RE	KL MS	SA MO	SA SP	SA RE	SA MS	MO SP	MO RE	MO MS	SP RE	SP MS	RE MS	Average
ESG	0.53	0.49	0.44	0.42	0.53	0.71	0.67	0.67	0.46	0.7	0.69	0.42	0.62	0.38	0.38	0.54
E	0.59	0.55	0.54	0.54	0.37	0.68	0.66	0.64	0.37	0.73	0.66	0.35	0.7	0.29	0.23	0.53
S	0.31	0.33	0.21	0.22	0.41	0.58	0.55	0.55	0.27	0.68	0.66	0.28	0.65	0.26	0.27	0.42
G	0.02	0.01	-0.01	-0.05	0.16	0.54	0.51	0.49	0.16	0.76	0.76	0.14	0.79	0.11	0.07	0.30