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The Impact of ESG Performance on Corporate Debt Financing

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Abstract:

Recently, the focus of global businesses has expanded from solely concentrating on financial results to incorporating sustainability assessments. Environmental, Social, and Governance (ESG) principles have now become crucial in evaluating long-term corporate value. Although an increasing number of firms are adopting ESG practices, the impact of ESG on debt financing—specifically in terms of costs, terms, and access to capital—remains unclear, particularly across different regions and industries. To address this gap, the present study examines nine key academic studies spanning from 2011 to 2022, as well as case studies of non-financial listed firms in both developed (EU, US) and emerging (China) markets, such as Nestle, Microsoft, and Toyota. Utilizing ESG ratings from MSCI, Sustainalytics, and Bloomberg, the study analyzes various debt indicators, including interest rates and bond yields. The study reveals that strong ESG performance significantly reduces financing costs by 10 to 25 basis points through lower credit risk and attracts more ESG - aligned capital, as seen in Toyota's oversubscribed 2022 ESG bonds. Additionally, ESG's impact varies by industry, with the energy sector benefiting from environmental improvements and the retail sector from strong social practices. Overall, ESG serves as both a "risk mitigator" and a "capital magnet" in debt financing. This study underscores the importance of integrating ESG into financial strategies and offers valuable guidance for lenders, investors, and regulators.

Keywords: ESG Performance; Corporate Debt Financing; Financing Cost; Credit Risk; ESG-Aligned Capital

1. Introduction

In recent decades, the global business landscape has shifted from focusing just on financial performance to assessing corporate sustainability, with environmental, social, and governance (ESG) principles becoming a main structure. ESG's roots lie in the 1960s "socially responsible investing"(SRI) movement,

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triggered by worries about pollution, labour abuses, and governance failures. Nevertheless, the term "ESG" was formally coined in the 2004 "Who Cares Wins" report (by UNGC, IFC, and leading financial institutions), which connected ESG to long-run corporate value and urged its integration into decision-making.

Over the past 20 years, ESG adoption has been faster because of three important factors: First, growing social awareness of climate change,biodiversity loss, and inequality has raised expectations for corporate responsibility--Consumers prefer ESG aligned brands, and employee select value-aligned employers. Simultaneously, global regulators have introduced ESG policies: The EU's SFDR mandates ESG disclosure for financial participants, the US SEC has proposed climate disclosure rules, and China's CSRC has implemented ESG guidelines for some firms. Third, institutional investors (e.g., BlackRock, Vanguard) have agreed with ESG concepts, recognizing its link to resilience, lower operational risks, and sustainable growth.

Nowadays, ESG is no longer optional but crucial for competitiveness, investment attraction, and stakeholder trust--Making in study of its relationship with corporate debt financing critical.

The paper investigates ESG (its three dimensions and rating systems), and then examines factors influencing debt financing costs (credit risk, information asymmetry, and market conditions). Furthermore, it analyzes ESG's direct and indirect impact mechanisms and concludes with effective guidance for optimizing ESG and debt strategies, plus suggestions for stakeholders. The study holds theoretical value by enriching ESG-finance research on debt financing and advancing information asymmetry and credit risk theories. Practically, it guides firms to cut debt costs and enhance credit access through strong ESG performance, aids investors in assessing creditworthiness, and informs regulators on boosting debt market transparency.

2. Theoretical Foundations

2.1 Overview of ESG Performance

ESG performance is evaluated by three different dimensions, reflecting a firm's impact and practices. Environmental dimension focuses on a firm's environmental footprint, like climate adaptation, energy efficiency, greenhouse gas emissions, waste management and biodiversity conversation. Social dimension covers stakeholder relationships--employees (labor rights, health, diversity), customers (satisfaction, information privacy), suppliers (supply chain ethics), and communities. Firms with fair wages, safe products, and community support showcase strong social performance, including human rights compliance in global supply chains. Governance dimension refers to a firm's oversight systems, including board composition, executive compensation transparency, shareholder rights, disclosure quality, and anticorruption controls. Good governance prevents scandals and ensures alignment with stakeholder interests.

Notably, these three dimensions are interconnected: strong environmantal performance can improve community health, while good governance makes sure that ESG risks are managed well. A comprehensive ESG evaluation assesses all three.

ESG rating agencies provide standardized scores to help stakeholders evaluate performance. Nevertheless, methodological differences, like indicators and weightings, cause rating variations for the same firm. This is a key challenge in the ESG area.

MSCI ESG Ratings evaluates 35 ESG issues and proprietary data, and considers industry-specific risks or chances. This approach allows for a tailored assessment of each firm's ESG performance within its respective industry context.

Sustainalytics measures ESG risk exposure and management on a negligible Severe scale, covering 20 issues across 13 sectors. Ir uses a bottom-up approach (company data analysis, engagement) and offers detailed rick and opportunity reports. This method offers in-depth insights into specific ESG risks and how they are managed.

Bloomberg ESG Disclosure Scores rates ESG transparency (0-100 scale) by assessing the completeness, timeliness, and relevance of disclosed data from reports, encouraging firms to improve disclosure practices. This encourages firms to improve their disclosure practices and provide more comprehensive ESG information.

Despite the efforts of these agencies to provide comprehensive assessments, standardization remains a challenge. The International Sustainability Standards Board (ISSB), established in 2021, is developing global voluntary disclosure standards to promote consistency and comparability of ESG data. This initiative aims to address the current lack of uniformity in ESG reporting and enhance the reliability and usefulness of ESG information for stakeholders.

2.2 Influencing Factors of Corporate Debt Financing Cost

Corporate debt financing cost (interest rates/yields on bonds, loans, or commercial paper) is shaped by three groups of factors: company-specific, market, and macroeconomic.

Company-specific factors demonstrate a firm's financial health and creditworthiness: Credit Risk: he risk of default on debt payments. Lenders assess it through financial ratios and credit ratings. Firms with high leverage, low liquidity or poor interest coverage face higher debt costs, while higher credit ratings reduce costs. Information

asymmetry occurs when borrowers have more financial information than lenders, leading to adverse selection (lenders charge higher rates to offset high-risk borrowers) and moral hazard (borrowers take risky actions post-loan). Transparent firms (timely disclosures, audits, investor engagement) reduce asymmetry and lower debt costs [1]. Company size and age also play a role. Larger, more established firms have lower risk--They have diversified operations, longer track records, and stronger bargaining power with lenders. In contrast, smaller or younger firms face higher asymmetry and risk, leading to higher debt costs.

Market factors reflect financial market conditions affecting debt supply and demand. Interest rates set by central banks (e.g., Fed Funds rate, ECB refinancing rate) provide a baseline for debt costs. Low rates cut debt costs, while high rates increase them. The term structure also matters, as long-term debt has higher rates than short-term debt because of interest rate and inflation risk. Market liquidity, the ease of buying or selling debts without price impact, affects investor risk. Liquid markets reduce costs for firms issuing debt, while illiquid markets require higher yields to compensate investors. Liquidity depends on issue size, market participants, and trading activity. Investor sentiment also plays a role. Bullish sentiment reduces debt yields, while bearish sentiment increases yields even for firms with stable credit risk.

Macroeconomic factors impact debt costs on a broader scale. Strong growth boosts firm sales and improves debt-servicing ability, reducing debt costs. Recessions or slow progress reduce profitability, boosting risk and costs, and render become more cautious. Inflation erodes purchasing power, so lenders require higher rates to compensate. Expected inflation drives long-term rates, while actual inflation influence short-term borrowing costs. High unemployment lowers consumer demand and firm revenues, increasing default risk--resulting in higher debt costs. Low unemployment supports firm performance, reducing credit risks and costs.

3. Impact Mechanisms of ESG Performance on Corporate Debt Financing

3.1 Direct Impact Mechanisms

ESG performance directly affects debt financing primarily through three channels tied to credit risk mitigation--each aligned with ESG's core dimensions:

First, strong environmental performance reduces a firm's exposure to climate-related risks, directly reducing credit risk. For instance, a firm with low greenhouse gas emissions and renewable energy investments faces lower regulatory risk (e.g., carbon taxes) and operational disruption (e.g., supply chain delays from extreme weather). This cuts the likelihood of cash flow shortages that can hinder debt repayment [2].

For example, Nestle's commitment to net-zero emissions and renewable energy investments allowed it to issue green bonds with a 2.3% yield in 2023, 15 basis points lower than its traditional bonds, due to lenders recognizing its effective environmental risk management.

Second, the social performance constructs trust with workers, customers and communities--lowering risks that disrupt operations and debt repayment. For employees, fair wages, safety measures, and diversity programs reduce turnover (reducing recruitment/training costs) and avoid labor strikes. For customers, product safety and data privacy prevent reputational damage and revenue loss. For communities, engagement (e.g., local job creation, environmental initiatives) avoids protests or regulatory pushback [3].

Patagonia , with its focus on fair labor practices and transparency, secured a revolving credit facility with a 1.8% interest rate in 2022, 20 basis points lower than industry averages, due to its low social risk and stable cash flows.

Third, strong governance lowers the risk of fraud, mismanagement, or ethical branches--key drivers of default. Autonomous boards offer oversight, avoiding executive decisions that prioritize short-term gains over long-run debt repayment. Transparent disclosure (including ESG data) lowers information asymmetry, and anti-corruption controls prevent legal penalties and reputational damage [4]. Microsoft's independent board, transparent executive compensation, and anti-corruption policies contributed to its Aaa rating and allowed it to issue sustainability bonds with a 1.5% yield in 2021, 10 basis points lower than its non-sustainability bonds.

3.2 Indirect Impact Mechanisms

ESG performance also impacts debt financing indirectly, via two main channels that boost a firm's access to capital and bargaining ability. The growth of ESG investing (over 35 trillion dollar in ESG-aligned assets globally in 2023) has created a bigger pool of capital; for high-ESG firms. ESG-focused lenders (e.g., BNP Paribas, Band of America) and investors prioritize firms with strong ESG performance, enhancing demand for their debt instruments. This higher demand lowers yields, as investors compete for exposure to sustainable firms [5]. For example, Toyota Motor Corporation--which has invested in hybrid/electric vehicles (environmental) and employee safety (social)--has consistently catch ESG-focused bond investors. In the year 2022, Toyota issued 200 billion RMB in ESG bonds, which were oversubscribed 3x. The bonds had a 0.8 percent yield--25 basis points lower than its traditional bonds. Toyota's CFO noted that ESG alignment expanded its investor base, giving it leverage to negotiate lower rates.

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Strong ESG performance benefits a firm's reputation, generating higher customer loyalty, market share, and revenue stability--all of which indirectly support debt repayment capability. A good reputation also lowers the risk of reputational crises (e.g., environmental scandals) that could trigger a fall in cash flow or credit rating [6]. Unilever's "Sustainable Plan" (focused on reducing environmental influence and improving social conditions) has improved its brand value--Unilever was ranked the world's most sustainable consumer goods firm in 2023. This reputation has translated to stable revenue growth (5-7 percent annually since 2020) and strong credit advantages. In 2023, Unilever secured a 2 billion dollar term loan with a 2.1 percent interest rate-18 basis points lower than its 2020 loan (before its ESG plan was fully implemented). Lenders cited Unilever's reputation-driven revenue stability as a key factor in the lower rate.

For corporations, the first step to leveraging GSG for better debt financing is prioritizing material ESG factors--those most relevant to their industry. For example, energy firms should focus on how to reduce carbon emission (environment), while retail firms should prioritize supply chain labor practices (social). Firms should also align ESG goals with debt strategies, such as issuing green/sustainability bonds (which often have lower yields) to fund ESG projects, or linking loan terms to ESG performance (e.g., lower rates for meeting emission targets).

Transparency is crucial, with firms adopting recognized ESG reporting standards to reduce information asymmetry with lenders [7]. Engaging with ESG rating agencies to clarify performance (e.g., explaining sustainability initiatives) can also promote ratings, as agencies often depend on public data that may not capture all efforts.

For investors and lenders, integrating ESG into credit analysis needs moving beyond financial metrics to assess long-term risk. This includes assessing a firm's ESG risk management (e.g., Task Force on Climate-Related Financial Disclosures, TCFD). Lenders can also design ESG linked financial goods (e.g., green loans, sustainability-linked bonds) to incentivize strong ESG performance, while investors can use ESG ratings to screen debt portfolios for lower risk [8].

For regulators, dealing with ESG standardization is a key. Establishing a global ESG disclosure framework (e.g., ISSB standards) will reduce rating inconsistencies and improve data quality [9]. Regulators can also offer incentives for ESG adoption--such as tax breaks for green bond issuers or preferential capital requirements for lenders that fund sustainable firms. Furthermore, monitoring ESG "greenwashing" (false or exaggerated ESG claims) will protect investors and ensure the integrity of ESG debt markets.

4. Conclusion

This paper explores the impact of ESG performance on corporate debt financing, highlighting three core conclusions: Initially, ESG performance directly lowers debt financing costs by mitigating credit risk--strong environmental performance reduces climate risks, social performance increases stakeholder stability, and governance decreases mismanagement risks. Second, ESG indirectly promotes debt access and terms by attracting ESG-focused capital and boosting reputation-driven revenue stability. Third, the benefits of ESG are industry-specific, needing firms to prioritize material factors and align ESG with debt strategies.

This study has two main limitations. First, its literature coverage is not fully comprehensive: It focuses on mainstream ESG-debt studies but does not include emerging work on regional differences (e.g., ESG's influence on debt in emerging markets VS developed economics). Simultaneously, the analysis relies on existing case studies (e.g., Nestle, Microsoft) instead of original empirical research. This limits the generalizability of findings, as case studies reflect individual firm contexts rather than broader market trends.

For future research, three areas are specifically promising: first, quantitative studies comparing ESG's impact on debt financing across regions (e.g., Asia VS Europe) would clarify how regulatory and cultural differences shape this relationship. Second, research on small and medium-sized enterprises (SMEs) is needed--most current studies focus on large firms, but SMEs face unique ESG and debt challenges (e.g., limited resources for ESG initiatives). Third, exploring the impact of "ESG integration maturity" (e.g., firms with embedded ESG VE those with superficial practices) on debt costs would help distinguish between genuine and performative ESG. For the industry, the future of ESG and debt financing will be defined by standardization and integration. As ISSB standards are adopted globally, ESG data will become more consistent, making it simpler for lenders and investors to evaluate risk. The growth of ESG-linked financial products (expected to reach 5 trillion dollar by 2025) will further align debt markets with sustainability goals. Additionally, technological advancements (e.g., AI for ESG data analysis) will improve the accuracy of ESG risk assessments, enabling more accurate pricing of ESG-aligned debt.

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