Daiwa Securities

Daiwa's View

Relationship between ESG and credit spreads

- Credit spreads tighten on improvement in ESG factors

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Credit spreads tighten on improvement in ESG factors

As ESG investment flows accelerate, the question of how to incorporate ESG factors into investment strategies is becoming an important theme for bond investors. With this as a backdrop, the Research Institute of Economy, Trade and Industry has published a paper entitled *Sustainability and Credit Spreads in Japan*[1].

The paper analyzes how companies' ESG scores affect the spreads on their corporate bonds. Specifically, it ran a regression analysis of the ESG score provided by Refinitiv against the credit spreads of the 2,353 bonds issued by 245 Japanese companies from 2007 to 2018, controlling for company factors such as rating and amount of revenue and for macroeconomic factors such as CPI and GDP growth rates. The results were as follows.

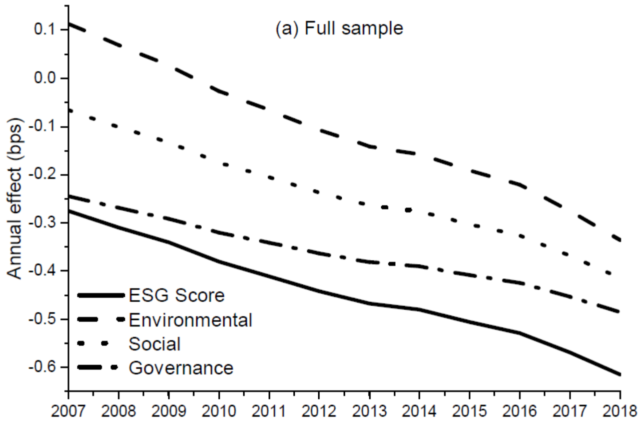
(1) *Companies with higher ESG scores had tighter credit spreads*
A 1ppt improvement in ESG score lowered credit spreads by 0.65bp
(2) Growth in ESG investment over the past few years has amplified this effect:
from 0.3bp in 2007 to 0.65bp in 2018
(3) The effect is larger for companies with lower credit ratings:
from 0.17bp for companies rated at least A to 3.25bp for companies rated BBB
(4) The factor with the largest impact was governance, followed by social and then environmental
G: 0.45bp; S: 0.39bp; E: 0.11bp

ESG factors are becoming increasingly important to bond investors

Why are spreads tighter on companies with a high ESG score? An analysis of the results of the paper noted above suggests two possible answers to this question. Either spreads tighten beyond their fair value because investors prefer companies with a high ESG score, or rational behavior by investors causes market spreads to accurately price in ESG factors that are not reflected in the credit rating or other metrics. If the first theory is correct, the best investment strategy would probably be to invest in companies with low ESG scores to earn higher yields, but if the second theory is the correct one, it may be possible to generate a stronger investment performance by raising an issuer's ESG score through engagement with that issuer. Lastly, looking at it from the issuer's perspective, if it is possible for a company to lower its cost of funding by improving its ESG score, it could mean that the financial system creates an incentive for companies to meet the social goal of improving sustainability. Although these wound up becoming somewhat controversial arguments, it appears that ESG factors are likely to become increasingly important to bond investors either way.

[1] Co-authored by Tatsuyoshi Okimoto (Associate Professor at Crawford School of Public Policy, Australian National University) and Sumiko Takaoka (Professor at Seikei University).

Effects of ESG Scores on Credit Spreads



Source: Extracted from the aforementioned paper.

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