The effect of bad news on credit risk: a media based view of the pricing of corporate social responsibility

EXECUTIVE SUMMARY

Julian Fritz Kölbel*[a], Timo Busch[b]
[a]Swiss Federal Institute of Technology Zurich (ETH Zurich), Department of Management, Technology, and Economics, Chair of Sustainability and Technology, Weinbergstrasse 56, 8092 Zürich, Switzerland
[b]University of Hamburg, School of Business, Economics and Social Science, Von-Melle-Park 9, 20146 Hamburg, Germany
*Corresponding Author: koelbelj@ethz.ch

There is a long-standing debate in the academic literature dealing with the question whether corporate social responsibility contributes to the financial performance of firms. We contribute to this debate by focusing on the media as an information source. We find that firms that are criticized in the news for a lack of corporate social responsibility have higher credit risk.

In this working paper, we take the view that financial performance is influenced by the information that is provided by the news. The news is easily available to investors and can therefore be reflected in investment decisions across the market. Based on this, a price effect should be observable following news on corporate social responsibility, if it matters to investors.

The study is focused exclusively on negative news based on data from RepRisk AG. For each company, we count the number of news per quarter that criticize the company for an issue related to corporate social responsibility. We included news from all sources including internet blogs, however news items are assigned a larger weight if they appear in a media outlet with larger readership.

Given that we only look at negative news, we expect an effect on downside risk. As a measure of financial performance we utilize credit risk measured by credit default swap spreads.

Our sample consists of 413 firms from all industries excluding financial services during the period from 2007 to 2012. The companies are based mainly in the United States and the European Union. We include control variables which also have an effect on credit risk: Credit Rating (AAA=1, AA=2 etc.), Leverage, Firm Size, Capital Intensity, Return on Assets, Interest Coverage and an indicator whether the firm has made an operating loss.

The model is a panel regression with firm and time fixed effects in order to prevent bias from factors such as industry affiliation or the financial crisis. The result is shown in the table below, which shows the coefficients (effects) of each variable on the logarithm of credit default swap spreads. The standard errors indicate the uncertainty around the coefficient and the stars indicate whether the coefficient is significant.

Variable	Coefficient	Standard Error
News Count	.010***	(.003)
Credit Rating	.248***	(.050)
Leverage	−.028	(.233)
Loss	.087*	(.034)
Firm Size	−.567***	(.065)
Capital Intensity	−.147	(.383)
Return on Assets	−.629*	(.277)
Interest Coverage	.000	(.000)
Adj. R^2	91%	
Num. obs.	7328	

***$p < 0.001$, **$p < 0.01$, *$p < 0.05$

The results show that the news count has a significant, positive coefficient, which means that more negative news on CSR issues are associated with higher credit default swap spreads. All other control variables have an effect in the expected direction. A battery of robustness checks has been performed to test this result, all of which indicate that the result is stable. We also show that the effect is present for firms in the US as well as for firms in Europe.

We argue that the direction of causality runs from news count to credit risk and not the other way around. This is based on the rationale that it is difficult to suppress negative news. Especially in a time of cell phone cameras, internet blogging and whistle blowing it is increasingly difficult to prevent information from entering the news. To back this up we perform a two stage least squares regression, which also supports the causal chain from news count to credit risk.

In practical terms, our results imply that an additional negative news item per quarter in a leading business paper is associated with an average increase of 3% of the credit default swap spread relative to its previous level. As an example, Firm A is normally mentioned twice per quarter in a negative way by a leading business paper and it has a credit default swap spread of 100. If next quarter, Firm A will be mentioned three times, its spread would move to 103.

The study shows that information on corporate social responsibility is relevant for fixed income investors. Furthermore, the study suggests that activists can exert a powerful influence with a good media strategy. Finally, the study highlights the importance of an independent and objective press for the debate about the social responsibilities of corporations.

The working paper can be downloaded at:

http://www.dsf.nl/assets/cms/File/Research/DSF%20Policy%20Paper%20No%2040%20The%20effect%20of%20bad%20news%20on%20credit%20risk_November%202013.pdf