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ESG AND THE COST OF CAPITAL: EXAMPLES FROM EASTERN EUROPE BANKING INDUSTRY

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Abstract

This paper aims to test the hypothesis that higher ESG scores lead to a lower cost of capital for publicly traded companies in Eastern Europe. In recent years, ESG factors have become increasingly important in the investment industry, influencing the cost of capital for publicly traded companies from banking industry. As companies seeking capital are increasingly scrutinized based on ESG factors, most publicly traded companies publish ESG disclosures and strive to be ESG compliant. Although there is no definitive governing body for ESG, capital providers benchmark companies based on ESG scores—either internally created or from external providers—and integrate these scores into their investment decisions. With cost of capital on the rise during previous period, the authors want to test the hypothesis that ESG score have positive influence on the cost of capital for public companies in banking industry, with lower cost of capital compared to their peers. Using the Weighted Average Cost of Capital (WACC), this paper breaks down the cost of capital to test the effect of ESG scores on both the cost of debt and the cost of equity for publicly traded banking corporations from Eastern Europe.

Key words: *ESG, Cost of Capital. Corporate finance.*

1. Introduction

ESG (Environmetnal, Social, Governance) represents set of non-financial factors that are used to assess the impact that the subject have on different stakeholders. According to the United Nations Principles for Responsible Investment (PRI, 2020) ESG factors encompass, but are not limited to:

- Environmental factors: climate change, resource depletion, waste, pollution, deforestation

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- Social factors: human rights, modern slavery, child labour, working conditions, employee relations
- Governance factors: bribery and corruption, executive pay, board diversity and structure, trade association, lobbying and donations, tax strategy

ESG is increasingly integrated into corporate evaluations, investment strategies, and policymaking, reflecting a shift towards sustainable and responsible business practices. The goal of any company is to maximize shareholders value, and ESG factors should therefore increase the value of the firm, but so far the results of different researches are inconclusive. Some previous researches found that ESG factors, as presented, increase shareholders values through improving company performance (Broadstock er al., 2020; Buallay 2019) while others (Devinney, 2009) argue that ESG could lead to opportunity costs associated with inefficiently allocated capital. Friedman go as far as to argue that socially responsible initatives to make world a better place should not be pursued as the sole responsibility of managers is maximization of owners wealth (Friedman, 1980).

One of the problems that authors encounter when analyzing ESG factors is large number of ESG score providers, each with different methodology that is usually proprietary ownership of ESG data provider. Most of ESG score providers are part of large financial services groups, such as: Bloomberg, Morningstar, MSCI etc.; Part of a stock exchange itself, such as FTSE; or specialised platforms formed by safety and environmental NOGs, like CDP or RepRisk. These ESG scores show convergence to an extent, but inability to assess different methodologies prevent researchers to use the most suitable ESG scores for their researches.

Most ESG score providers put greater emphasis on Social and Governance factors when assesing banking industry. Althouhg banking industry doesn't have direct environmental impact, it does have indirect influence through financing different projects that could have negative environmental impact. However, there is some evidence from European banking market than environmental dimension of ESG influence bank value (Azmi et al., 2021).

Banking industry in Eastern Europe area is characterized by mix of wholly owned subsidiaries, partially owned subsidiaries and independent banking corporations, with most of the wholly and partially owned subsidiaries owned by banks from either Western Europe or United States of America. Besides other banking institutions, governments, equity funds and other private owners are present on the market as well. This makes most of banks that are present on the domestic stock exchanges the basis of the market, their stocks attracting high investors attention and making them constituents of most important market indices.

1.1 Section (methods)

Banking industry is specific when compared to other industries because one of its main functions is to aggregate debt financing so it can distribute funds to other entities in need of financing. Because of that, it can be presumed that debt will be prevalent source of capital in banking industry. Also, because most of debt for

companies is generated through deposits by individuals and institutions, calculation of debt cost should take cost of deposits into account.

WACC represents standard measurement of funding cost, either for company, part of the company or separate project. It considers all sources of funding and its associated costs and weights them according to the share of each funding source in financing. We used Capital Asset Pricing Model (CAPM) to calculate cost of equity capital. For cost of debt, we used interest expenses on interest-paying liabilities. Although in its basic form cost of debt is expressed as current yield on company debt securities, our reasoning to deviate from usual practice is because structure of liabilities in banking industry, as majority of interest-paying liabilities are not in debt but in deposits from clients. Taking into account both deposits and other interest paying liabilities, we arrived at real cost of borrowed capital. Because interests on deposits are usually much smaller than interest on other debt, and that deposits carry most of the liabilities, the cost of debt is expected to be smaller than if we used standard methodology.

As a source of ESG ratings we used Sustainalytics, which is part of Morningstar, Inc. financial group. Sustainalytics provide total ESG score in range from 0 to 40+, with lower scores showing lower ESG risks and better ESG management. Each industry has different sets of observable variables that define that industy, and the ranking among companies inside industry is provided. For this paper, companies are ranked according to their ESG scores on 10th of September 2024. We ranked Eastern European banks according to their Sustainalytics ESG score.

We use Spearman's rank correlation coefficient to test if the rankings of the banks according to ESG influence ranking of banks according to cost of equity, cost of debt and WACC, with larger Spearman's rank correlation coefficient points to the stronger connection between ESG ranks and cost of capital for the banks. Since Sustainalytics is providing only the curent score, not its previous values, Spearman's rank correlation coefficient is adequate to capture the relationship between ESG scores and cost of financing. We hypothesize that there should be positive correlation between ESG score ranks and cost of debt, cost of equity and WACC ranks.

2. Section (results)

First, we calculated the cost of equity, cost of debt and WACC for observed banks (Table 1.). From it can be observed that 8 out of 14 of banks used in this research were from Poland, and some of them were part of larger banking groups, however their ESG scores were independent of ESG scores of parent companies.

Table 1: List of banks with cost of equity, debt, WACC and Sustainalytics ESG score

Name	Country	Cost of equity	Cost of debt	WACC	ESG
Alior Bank	Poland	81.264%	2.943%	10.355%	24.2
Banca Transilvania	Romania	21.662%	2.639%	3.820%	13.3
Bank Handlowy	Poland	-1.619%	1.784%	1.073%	22.0
Bank Millennium	Poland	65.619%	2.755%	5.701%	23.0
Bank PEKAO	Poland	14.510%	2.208%	2.932%	22.5
ING Bank Slaski	Poland	39.822%	1.858%	3.685%	16.0
Komercni Banka	Czechia	-4.097%	7.066%	4.927%	22.2
mBank	Poland	15.647%	2.550%	2.926%	12.8
MONETA money bank	Czechia	5.228%	3.406%	2.923%	15.6
Nova Ljubljanska Banka	Slovenia	39.787%	0.985%	5.198%	14.6
OTP Bank	Hungary	17.260%	3.755%	4.854%	14.5
PKO BP	Poland	27.120%	2.599%	4.481%	23.9
Santander Bank Polska	Poland	22.264%	2.175%	4.148%	16.0
Tatra banka	Slovakia	9.316%	1.802%	1.997%	18.3

The results of Spearman's rank correlation coefficient (Table 2.) for show that there is no correlation between the cost of equity, cost of debt, or WACC with ESG score, implicating that ESG scores do not have any kind of influence on WACC or any of its constituents.

Table 2: rankings and Spearman's rank correlation coefficient

Bank	de	dd	dw	de2	dd2	dw2
Alior bank	0	-3	0	0	9	0
Banca Transilvania	6	7	5	36	49	25
Bank Handlowy	-7	-7	-8	49	49	64
Bank Millenium	-1	-2	-4	1	4	16
Bank PEKAO	-6	-5	-6	36	25	36
ING Bank Slaski	7	-3	-1	42	6	0
Komercni Banka	-9	4	2	81	16	4
mBank	5	6	3	25	36	9
MONETA money bank	-2	7	-2	4	49	4
Nova Ljubljanska Banka	8	-3	9	64	9	81
OTP Bank	4	10	8	16	100	64
PKO BP	-3	-5	-3	9	25	9
Santander Bank Polska	3	-2	3	6	2	6
Tatra banka	-4	-5	-6	16	25	36
			ρ =	0.15275	0.11099	0.22088

3. Section (discussion)

ESG scores do not have any influence cost of equity, cost of debt or weighted average cost of capital for Eastern European banks, showing that both constituents of WACC are independent of ESG scores.

These results show that good ESG governance does not cause benefits in cost of funding for the banking institutions, which contradicts one of the purposes of ESG.

Good governance should at least improve the cost of financing as it should provide better transparency and accountability of management, as well as better cost management. Environmental aspect of ESG depends on methodology, however when there is no benefit for banks and their shareholders when they engage in different environmental actions, there is a possibility that banks would not prioritize projects or would not engage in activities that are environmentally friendly.

To be meaningful, we argue that good ESG scores should show good correlation with financial performance of banks, as capital providers are interested in their own returns. If pursuing ESG scores does not influence their own benefit, there is a possibility that banking industry would consider ESG aspect as nuisance, not as an important part of their strategy. If good ESG governance does not correspond with either lower cost of equity or lower cost of debt, there is no reward for being "good" and only by forceful implementation banks will keep on following ESG guidelines. Debt providers (both institutional and private) should reward banks with higher ESG scores with lower interest rates, while equity providers should ask for lower expected stock appreciation.

4. Section (conclusions)

This study examines influence of ESG scores on cost of financing shown through Weighted average cost of capital. At the beginning we gave a short glance at literature overview concerning Environmental, Social and Governance ESG factor, with detailed overview of ESG factors in banking industry. The universe of ESG data providers is presented, with their most obvious similarities and differences pointed out.

We argued for using extended WACC to capture the cost of deposits, not just cost of debt that is part of WACC. For equity, we used Capital asset pricing model, while for debt we used interest expense over interest bearing liabilities. For weights we used market values of both debt and equity. For ESG scores we used scores provided by Sustainalytics. By using Spearman's rank coefficient correlation, we established that there is no correlation between ESG scores and cost of funding, either debt, capital, or combined.

For ESG to have influence, we argue that there should be positive correlation between cost of capital and ESG scores. If pursuing ESG principles does not provide any benefit to the banks, there is a possibility that banks would consider ESG as nuisance, and not as principles of good governance that should

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