Chapter 9

Effect of Corporate Social Responsibility on Pricing of Small Business Loans:
Evidence From Finland

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ABSTRACT

This study analyzes corporate social responsibility (CSR) issues in small business finance in Finland, especially within relationship banking. The study combines credit-file data obtained from a large local Finnish bank with a CSR questionnaire conducted with the bank's business loan managers. The credit-file data contain specific details of CSR characteristics, as well as relationship-, collateral-, firm-, and loan-specific characteristics. CSR, typically considered as a non-financial item, contains value-relevant financial information which affects the loan pricing level. The results show that both overinvestment in CSR and the value created by CSR are valid but connected to different CSR characteristics. Overinvestment is associated with the environment and value creation with diversity and employees. The results contribute to the understanding of the characteristics of CSR in the context of small business bank lending, as well as more generally to important implications for small firms, banks, and management practices.

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INTRODUCTION

Debt financing opportunities are crucial, especially for small companies. Large body of literature refers to the strong role of debt financing, even being more important to small businesses than equity financing (Berger & Udell, 1998; Frame, Srinivasan & Woosley, 2001; Hyytinen & Pajarinen, 2002; Wu & Chua, 2012). Because most of the debt in small firms is financed by banks, it is important to understand how banks take into account the variety of information available of the company when making loan decisions and its terms. Previous research has demonstrated that financial performance of the bank client and characteristics of the bank/firm relationship have important effects on loan decisions (see e.g. Elyasiani & Goldberg, 2004). However, the effects of non-financial information, especially firms' corporate social responsibility (CSR) on loan decisions, are unclear (Goss & Roberts, 2011; El Ghoul, Guedhami, Kwok & Mishra, 2011; Rosa, Libratore, Mazzi & Terzani 2018).

Previous research suggests that the relationship between CSR and financial performance is not straightforward. On the one hand, costly CSR initiatives of a firm can be understood as a deviation from the goal of shareholder wealth maximization (Barnea & Rubin 2010). On the other hand, CSR can have a risk mitigation role preventing externalities of irresponsible acts of a firm to the society not shift back to the explicit costs of the firm (Heal 2004; Goss & Robers 2011). Finally, CSR can signal firm operation to outsiders (Dhaliwal, Li, Tsang & Yang, 2014; Michelon, Pilonato & Ricceri, 2014). This suggests that the CSR initiatives can have either positively, neural or even negatively associated with financial performance. Goss and Roberts (2011) suggest loan securitisation signals whether lender posit CSR activities coming from high or low-quality borrowers. However, Hoepner, Oikonomou, Scholtens and Schröder (2016) did not find conclusive evidence CSR effect of the interest rates of bank loans.

This study enters the topic from unique perspective by collecting information of firms CSR performance by questionnaire conducted with the bank's business loan managers in small businesses. Since the banks often demand access to proprietary information about the firms that may not be available to other outsiders (Goss & Roberts, 2011) it is possible that bank can have information about, among other things, clients' environmental and social performance. Thus, banks can exploit their unique position to client's private information (Armstrong, Guay & Weber, 2010, p. 214) by pricing CSR in terms and conditions of loan agreement. Second, our study complements research by using non-US data with different institutional setting. Unique credit-file data from a large local Finnish bank are explored. The data contain specific details of corporate social responsibility characteristics, and relationship-, collateral-, firm-, and loan-specific characteristics between 1995 and 2001. Finally, our study complements Goss and Roberts's (2011) study, which focus on multiple banks and larger firms by examining loan pricing for smaller firms and single local bank. Local banks may have better access to customers' financial and non-financial information than distant lenders.

The rest of the paper is organized as follows. In the next section, overinvestment and value-creation contexts and hypothesis are discussed. Section 3 describes the methodology and data. Section 4 reports results and Section 5 concludes the paper.

BACKGROUND

Prior research suggests several theoretical underpinnings how the cost of debt is associated with CSR. They involve (i) the overinvestment view arguing that CSR investments represent increased costs, result-

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