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Does Corporate Sustainability Matter for Capital Structure Decisions?

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Policy Brief No. 009 | June 2025

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Keywords:

Capital Structure, ESG, Corporate Sustainability, Financial Resilience, OIC

SDGs:

8, 9

Highlights:

- *Environmental, social and governance (ESG) adoption can significantly influence how firms in Organization of Islamic Cooperation (OIC) countries secure debt, particularly under crisis conditions.*
- *Firms that demonstrate environmentally conscious practices, socially responsible policies, and transparent governance often gain greater credibility in the eyes of creditors.*
- *This credibility is linked to lower perceived risk, which can translate into better lending terms and more flexible credit lines.*
- *Throughout the COVID-19 pandemic, ESG-aligned firms showed enhanced resilience, maintaining or even improving leverage ratios when others faced higher borrowing costs and tighter credit conditions.*
- *In contrast, firms lacking robust ESG measures struggled to secure favorable debt, indicating that sustainability commitments can serve as both strategic advantage and form of risk insurance for OIC economies.*

Does Corporate Sustainability Matter for Capital Structure Decisions?

In recent years, growing attention has been directed toward ESG concerns among firms, consumers and investors, influenced partly by regulatory requirements in developed countries. Companies, especially those in advanced economies, are both adopting and promoting ESG initiatives to address investor priorities and potentially benefit from various incentives. Investors often regard ESG efforts as credible indicators that lower perceived risk (Lee and Kim, 2016; Sassen et al., 2016) and bolster firm value (Lins et al., 2017). In addition, ESG programs foster stakeholder trust, help firms navigate crises (Albuquerque et al., 2020; Ding et al., 2021) and function as a form of insurance against adverse conditions (Bae et al., 2019). By reducing financial constraints and bringing down capital costs, ESG activities are also tied to improved firm performance (El Ghoul et al., 2011; Goss and Roberts, 2011; Cheng et al., 2014).

Research indicates that companies committed to ESG principles often benefit from enhanced market credibility and lower perceived risk, allowing them to obtain better terms on external financing (Houqe et al., 2020). Such findings are especially relevant in economies where trust deficits and informational gaps can exacerbate the cost of capital. ESG performance includes concrete steps such as reducing waste, ensuring fair labor conditions, and adhering to transparent governance. When firms publicly disclose progress in these areas, lenders tend to respond positively, perceiving ESG adoption as an indicator of efficient management and long-term resilience. This effect becomes all the more important during major disruptions—such as global pandemics—that amplify uncertainty.

Capital structure, referring to the balance between debt and equity, is fundamental to every firm's financial strategy. In OIC economies, where concerns about market volatility and trust can escalate borrowing expenses, securing the right mix is a constant challenge. The COVID-19 crisis brought these challenges into sharper focus, as many businesses faced heightened economic stresses. ESG practices, previously seen by some as optional or purely reputational, have emerged as potential shock absorbers. Companies that have implemented sustainability initiatives—for instance, emphasizing environmental responsibility or providing clear disclosures on labor standards—are often viewed by creditors as less risky. The reporting of ESG metrics not only signals to lenders that management is forward-thinking but also suggests the firm is well-prepared for adversity. Implementing such initiatives is not merely a branding exercise; it typically involves restructured supply chains, workforce training, and improved governance oversight, all of which can sustain a company's financial stability over time.

During the COVID-19 pandemic, ESG became a decisive factor in distinguishing firms with the capacity to maintain stable leverage ratios from those that struggled with credit availability. Recent evidence has shown that companies with robust ESG frameworks managed to secure better terms, whereas those lacking clear sustainability commitments encountered steeper interest rates or restrictive conditions (El Ghoul et al., 2011; Cheng et al., 2014). This gap underscores the importance of ESG as a mechanism for mitigating risk, boosting transparency, and instilling greater confidence among investors and lenders.

Several empirical studies now suggest a positive correlation between ESG engagement and a firm's leverage capacity (Zhang and Liu, 2022). Two core reasons explain this pattern. First, stronger sustainability and governance protocols often correspond with more stable revenue streams, better risk management, and reduced operational hazards. Such stability appeals to lenders, especially when market wide risk aversion intensifies. Second, the act of publishing detailed ESG reports reduces information asymmetry. Creditors, wary of hidden liabilities or governance weaknesses, tend to view clarity around social and environmental practices as a sign of sound management. As a result, these firms frequently receive more favorable terms and may leverage more comfortably without unsustainable debt burdens.

During global downturns, such as the COVID-19 crisis, this impact becomes amplified. Firms with credible ESG commitments faced fewer sharp increases in borrowing costs compared to companies perceived as riskier due to minimal disclosure or questionable practices (El Ghoul et al., 2011). OIC countries, in particular, highlight the differences ESG can make, revealing how sustainability-oriented enterprises sustained financing channels under conditions that proved daunting for many peers.

Using firm-level data covering two decades in 20 OIC member nations, Tekin and Polat (2025) reveals a consistent link between ESG initiatives and capital structure choices. By aligning corporate strategies with recognized sustainability standards, firms with higher ESG scores appeared to earn greater trust from both domestic and international financiers. However, results vary across countries, influenced by differences in regulatory policies, cultural norms, and market maturity. In Saudi Arabia and Indonesia, for instance, ESG-focused firms often saw leverage climb without overly punitive interest rates, suggesting that lenders acknowledged their stronger risk profile. In Malaysia, some highly rated ESG firms opted to lower their leverage levels during COVID-19, possibly reflecting a strategic preference for caution when economic signals were uncertain. This cross-country variance illustrates how ESG frameworks can shape both corporate decision-making and lending conditions, underscoring the need for policymakers to contextualize sustainability measures to local market realities.

ESG practices do more than enhance reputations; they can act as a hedge against unexpected shocks. Major crises, such as the global financial downturn of 2008 and the ongoing pandemic, erode investor confidence and drive up borrowing costs. Under such circumstances, banks and bond markets often adopt stricter lending criteria. Firms that have already embraced ESG tend to withstand these stresses more effectively, partly because their operational policies and stakeholder relationships are designed with long-term risk mitigation. These companies may have business continuity plans, greater supply chain oversight, and diversified lines of revenue, all of which reduce default risk. From a capital structure perspective, the capacity to navigate market disruptions without defaulting fosters a virtuous cycle: lenders see fewer red flags, so the firm maintains or even improves its debt access despite broader economic instability.

Policymakers in OIC nations can play a pivotal role in aligning ESG adoption with the achievement of SDG 8 (Decent Work and Economic Growth) and SDG 9 (Industry, Innovation, and Infrastructure). By introducing practical measures like tax credits, simplified certification processes, and grant programs, they reduce financial barriers that might otherwise hinder businesses—particularly small and medium enterprises—from investing in sustainability. These policy levers can generate more robust economic growth (SDG 8) by spurring new job opportunities in environmental auditing, green technology, and socially responsible governance. At the same time, uniform disclosure standards enable better comparison of ESG performance across firms, fostering a culture of transparency and innovation that strengthens industrial frameworks (SDG 9). Linking loan rates to sustainability metrics and expanding green sukuk or other Islamic finance instruments similarly brings capital into responsible projects, enhancing infrastructure resilience and stimulating sustainable industrial practices that accelerate economic diversification and technological advancement. Training and educational workshops, moreover, guide smaller businesses toward meaningful ESG initiatives, ensuring they have the practical knowledge to implement reforms that improve labor conditions (SDG 8) and encourage innovation in production and supply chain management (SDG 9).

ESG practices, when clearly tied to SDG 8 and SDG 9 objectives, become a key factor shaping capital structure decisions in OIC economies. Integrating environmental responsibility, social commitments, and robust governance mechanisms strengthens a firm's position in financial markets, increasing its access to stable and cost-effective funding. This heightened financial security contributes to the creation of decent work opportunities (SDG 8) through economic expansion and supports infrastructure development by driving sustainable industrialization (SDG 9). Regulators and financial institutions alike can reinforce these aims by requiring clear ESG reporting, offering strategic incentives, and supporting green finance products. In an environment where unforeseen crises like COVID-19 may disrupt economies, ESG frameworks help stabilize labor markets (addressing SDG 8's focus on job security) and safeguard infrastructural investments (aligning with SDG 9's emphasis on resilient and sustainable industrial growth). As OIC firms adopt these principles, they become better equipped to maintain a competitive edge, ensuring that economic development remains both equitable and future-proof.

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