CAN ETHICAL BEHAVIOR REDUCE CREDIT RISK? FOCUS ON THE MODERATOR ROLE OF THE BOARD OF DIRECTORS

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Abstract

The purpose of the study is to investigate whether companies that act ethically benefit in terms of reducing credit risk and if the board of directors (BoD) characteristics play a moderator role in the relationship between the presence of the legality rating and the credit risk. The study sample consists of 285 Italian companies between 2012 and 2022. The information related to the legality rating (LR) was taken from the Authority Guarantor of Competition and the Market (AGCM) and the other information associated with the companies was from the AIDA database by Bureau Van Dijk. The results of the study show a positive and statistically significant relationship between the LR and the EM-Score and a positive association between women on the BoD and the EM-Score. Moreover, the research reveals that the presence of women on the BoD amplifies the relationship between LR and credit risk.

1. INTRODUCTION

Legality rating (LR) was introduced by the Italian legislature in 2012. Companies voluntarily adopt LR to demonstrate their ethical behavior. The benefits reported from adopting the LR are many and explicable from various points of view. For example, companies with a higher LR

can obtain simplified access to public financing and bank credit. They also benefit in terms of reputation, greater visibility in the market, and competitive advantages over competitors (Caputo & Pizzi, 2019).

Companies that apply for the LR can obtain one to three stars, recognized by the Authority Guarantor of Competition and the Market (AGCM) if there are minimum requirements for compliance with tax regulations and the absence of criminal convictions. The rating lasts two years and can be renewed upon expiration, but it can lapse if the basic requirements are no longer present.

DeBenedetto et al. (2024) and La Rosa et al. (2023) argue that LR can be an effective corporate governance mechanism. Indeed, LR certifies corporate transparency and willingness to operate within the boundaries of the law and increases corporate credibility and trustworthiness among stakeholders to attract lenders (Branco & Rodrigues, 2006; Alwi et al., 2017; Wanner & Janiesch, 2019).

The certifying effect of the legality rating is an element that demonstrates the good ethical and legal conduct of companies, and this reduces information asymmetries significantly. This allows companies to leverage and build relationships with banks or private lenders. The existing literature (Pizzi et al., 2020) shows that because of the transparency benefits LR brings to companies, it is a financial stabilization tool, helping banks to identify companies' lower credit risk.

2. MAIN PURPOSE

Our study aims to contribute to the existing literature (Gong & Ho, 2018; Orazalin et al., 2019; Gangi et al., 2019; Pizzi et al., 2020) investigating whether companies that act ethically benefit in terms of reducing credit risk. Moreover, we want to examine if the board of directors (BoD) features play a moderator role in the relationship between the presence of the legality rating and the credit risk. So, we propose two research questions:

RQ1: How does LR affect firms' credit risk?

RQ2: How do BoDs moderate the relationship between the presence of the LR and firms' credit risk?

To answer our RQs, contrary to previous studies (Gangi et al., 2018; Orazalin et al., 2019; Pizzi et al., 2020), we do not use the Altman Z-Score (Altman, 1968) as a dependent variable, but the EM-Score. This is a measure of credit risk that starts from the application of Altman's Z-Score (Altman et al., 1998). Altman and Hotchkiss (2005) identify a correspondence between the Z-Score and the ratings assigned by Standard & Poor's to bonds. This choice is because our study wants to compare compliance with the legality rating provided by AGCM and the credit rating offered by the Standard & Poor's rating agency.

3. METHODOLOGY

Our sample consists of 285 Italian companies between 2012 and 2022. In line with previous research (Pizzi et al., 2020), we consider this period because 2012 represents the first year the LR was introduced, while 2022 is the last year in which data related to the variables included within our analysis are available. We downloaded the information related to the LR from the AGCM. Instead, the other information associated with the companies is downloaded from the AIDA database provided by Bureau Van Dijk. We perform a panel regression. Our dependent variable is the EM-Score (Altman & Hotchkiss, 2005) as a proxy of companies' credit risk. Our independent variable is the LR. Moreover, as moderator variables, we include females on the board, the board size, and the presence of independent directors (Carter et al., 2010; Arena et al., 2015; Francis et al., 2015). We also use financial and non-financial information as control variables. Specifically, we include liquidity, leverage, firm size, and experience (Orazalin et al., 2019; Pizzi et al., 2020).

4. FINDINGS

The results show a positive and statistically significant relationship between the legality rating and the EM-Score. This implies that companies that have applied for and obtained the LR are less exposed to the probability of failing. Our study adds value by examining the moderating effect of corporate governance mechanisms in this relationship. Our results indicate a positive association between women on the BoD and the EM-Score. The same can be asserted for the presence of independent directors. Furthermore, the study reveals that the presence of women on the BoD amplifies the relationship between LR and credit risk. The same is true for the moderating role played by the presence of independent directors.

5. IMPLICATIONS

Our study contributes to the existing literature because it helps to understand the usefulness of LR adoption for firms. However, it aims to explain how the composition of BoDs moderates the relationship between the presence of LR and firms' credit risk. LR acts as a certification of ethical management and a corporate governance tool, improving reputation and stakeholder trust. By reducing information asymmetries and improving transparency, LR adoption can mitigate credit risk and facilitate better access to finance. The analysis suggests that the composition of the BoD, as gender diversity and independent directors, plays a crucial role in moderating the relationship between LR adoption and credit risk. Promoting the adoption of LRs and diverse and independent BoD can help make financial ecosystems more stable and improve risk management practices, with both policy and practical implications.

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