A Theory of ESG Monitoring in Financial Contracts

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Abstract

We develop a model of ESG investing where firms have private information about their ESG commitment: some value non-pecuniary payoffs from green investment, while others opportunistically greenwash. Lenders choose whether to include an ESG-monitoring covenant that imperfectly detects greenwashing. Monitoring disciplines opportunistic borrowers, but sustaining it requires a lending discount that partly becomes an informational rent for intrinsically ESG-oriented firms. Therefore, monitoring adoption is non-monotonic in verification capability and occurs only at intermediate levels. Furthermore, lender competition yields state-dependent effects: it discourages monitoring when the lender's best alternative is pooled lending, but can encourage monitoring against selective lending to green firms. Particularly, in the latter case, competition may increase the prevalence of ESG discipline while shifting the market toward lower-intensity monitoring regimes.

Keywords: Socially responsible investments, ESG, asymmetric information, investor monitoring, financial market structure

JEL Codes: D82, D86, G23, G31

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