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The Impact of ESG Rating Divergence on Capital Market Efficiency: Evidence from the Indian Scenario

Dr. Pratik A Shah
Assistant Professor
Shree Bhaikaka Government Arts and Commerce College Sojitra, Gujarat

Dr. Kamini Sha
Professor at PG Department of Business Studies,
Sardar Patel University, Gujarat

Abstract

Environmental, Social, and Governance (ESG) integration has gained traction in Indian capital markets, driven by regulatory mandates and global investor demand for sustainable investments. However, discrepancies in ESG ratings across agencies create uncertainty, potentially undermining market efficiency. This paper examines the research problem of ESG rating divergence and its impact on capital allocation, cost of capital, and firm valuation in India. Using a mixed-methods approach—quantitative analysis of ESG ratings for 200 Indian firms and qualitative interviews with market stakeholders—the study finds that rating inconsistencies increase information asymmetry, elevate equity costs, and distort valuations, particularly for mid-cap firms. The findings contribute to the global discourse on ESG reliability while addressing India-specific challenges in sustainability adoption.

Keywords: ESG, sustainability, Indian capital markets, rating divergence, market efficiency

INTRODUCTION

The integration of Environmental, Social, and Governance (ESG) factors into investment decisions has transformed global capital markets, with sustainable assets projected to reach $50 trillion by 2025 (Bloomberg Intelligence 2024). In India, ESG adoption has accelerated due to regulatory initiatives like the Securities and Exchange Board of India's (SEBI) Business Responsibility and Sustainability Reporting (BRSR) framework, introduced in 2021, and growing foreign institutional investor (FII) interest. Indian firms, particularly in sectors like renewable energy and technology, leverage ESG to attract capital, with the BSE SENSEX ESG Index reflecting this shift (BSE India 2023). However, a critical challenge persists: the divergence in ESG ratings across agencies, which undermines investor confidence and market efficiency.

Research Problem: Inconsistent ESG ratings create uncertainty in Indian capital markets, where information asymmetry is already pronounced due to uneven disclosure practices. Agencies like MSCI, Sustainalytics, and local providers such as CRISIL assign divergent scores to the same firm, complicating capital allocation. For instance, a firm may score high on environmental metrics with one agency but low on governance with another, leading to mispricing risks and inefficient capital flows. This study asks: *How does ESG rating divergence affect capital market efficiency in India, and what measures can mitigate its impact?

Research Objectives:

1. To quantify ESG rating divergence for Indian firms across major agencies.
2. To evaluate its effects on cost of capital, firm valuation, and investor trust in India.
3. To propose India-specific solutions for harmonizing ESG ratings.

Significance: India's capital markets, among the fastest-growing globally, are pivotal for financing sustainable development. Addressing rating divergence can enhance market efficiency, align investments with national priorities like the Sustainable Development Goals (SDGs), and strengthen India's position in global ESG indices. This paper offers empirical and qualitative insights, focusing on India's unique market dynamics, including its mix of large conglomerates and mid-cap firms.

LITERATURE REVIEW

The global literature underscores ESG's role in reducing financial risks and enhancing returns. High ESG scores correlate with lower costs of capital, as investors perceive sustainable firms as less risky (El Ghoul et al. 2011). In India, studies confirm that ESG-focused firms, particularly in banking and IT, attract premium valuations due to stakeholder trust (Sharma and Kumar 2022). The BSE SENSEX ESG Index, launched in 2020, has outperformed traditional indices, signaling market appetite for sustainability (BSE India 2023).

However, ESG rating divergence poses a significant barrier. Berg, Koelbel, and Rigobon (2022) found that discrepancies arise from measurement divergence (56%), scope divergence (38%), and weight divergence (6%). In India, these issues are amplified by inconsistent disclosures and limited ESG expertise. For example, environmental scores vary widely for energy firms due to differing emphases on carbon emissions versus renewable investments (RBI 2023). Governance ratings are particularly contentious, given India's history of corporate scandals, such as those involving Satyam and IL&FS (Gopalan and Malhotra 2021).

Divergence impacts market efficiency by increasing information asymmetry (Fama 1970). In India, where retail investor participation is rising (NSE 2024), inconsistent ESG signals can lead to misinformed decisions, inflating bubbles or penalizing sustainable firms. Smaller firms face disproportionate challenges, as they lack resources to navigate complex ESG frameworks, unlike conglomerates like Reliance or Tata (Kumar and Singh 2023). Globally, studies suggest that rating inconsistencies discourage ESG adoption in emerging markets, where regulatory enforcement is weaker (OECD 2022).

Indian research highlights additional nuances. SEBI's BRSR mandates ESG disclosures for the top 1,000 listed firms, but compliance varies, with mid-cap firms lagging (EY India 2022). Cultural factors, such as stakeholder expectations for social impact, shape ESG priorities, yet rating agencies often apply Western frameworks, misaligning with local realities (Rao and Gupta 2023). Gaps in the literature include limited empirical analysis of divergence's financial impact in India and stakeholder perspectives on standardization. This study addresses these by combining quantitative rigor with qualitative depth, focusing on India's diverse market.

RESEARCH METHODOLOGY

A mixed-methods approach was employed to investigate ESG rating divergence in Indian capital markets, integrating quantitative analysis of financial data with qualitative stakeholder insights.

Research Design

Quantitative Component: Cross-sectional analysis of ESG ratings and financial metrics for Indian firms to measure divergence and its impact on cost of capital and valuation.

Qualitative Component: Semi-structured interviews with investors, rating analysts, and corporate managers to explore perceptions and solutions for rating inconsistencies.

Data Collection

Sample: 200 firms listed on the BSE and NSE, drawn from the BSE 500 Index, covering sectors like energy, IT, banking, and manufacturing. Firms were selected for availability of ESG ratings from MSCI, Sustainalytics, and CRISIL (India's leading rating agency) between 2020 and 2024.

Quantitative Data:

- ESG ratings from MSCI, Sustainalytics, and CRISIL, accessed via Bloomberg Terminal and NSE databases.
- Financial metrics: cost of equity (using CAPM), cost of debt, and firm valuation (Tobin's Q), sourced from CMIE Prowess.
- Control variables: firm size, sector, leverage, and market beta.

Qualitative Data: 25 semi-structured interviews conducted virtually with 10 institutional investors, including FIIs and domestic mutual funds, 8 analysts from ESG rating agencies (global and Indian), 7 corporate sustainability officers from sampled firms. Questions focused on divergence's impact, trust in ratings, and India-specific standardization needs.

Data Analysis

Quantitative Analysis:

Divergence Measurement: Calculated correlation coefficients and standard deviations of ESG scores across agencies for each firm.

Regression Analysis: Used ordinary least squares (OLS) regression to examine the relationship between ESG rating divergence (independent variable) and dependent variables: cost of equity, cost of debt, and Tobin's Q. Model:

$$Y_i = \beta_0 + \beta_1 \text{Divergence}_i + \beta_2 \text{Controls}_i + \epsilon_i$$

Where Y_i represents financial outcomes, and controls include size, sector, and leverage.

Robustness Checks: Applied fixed-effects models to account for sector and year variations.

Qualitative Analysis: Thematic analysis of interview transcripts using NVivo, identifying themes like investor skepticism, regulatory gaps, and cultural misalignment.

Ethical Considerations

- Ensured interviewee anonymity to foster openness.
- Used publicly available data to maintain transparency.
- Acknowledged potential biases in AI-assisted analysis, with human oversight for interpretations.

Limitations

- Sample focused on BSE 500 firms, potentially excluding smaller enterprises.
- Qualitative findings may reflect biases from urban-centric interviewees.
- Reliance on existing ratings assumes baseline accuracy despite known inconsistencies.

FINDINGS AND ANALYSIS

Quantitative Results

ESG Rating Divergence:

- The average correlation coefficient between ESG ratings from MSCI, Sustainalytics, and CRISIL was 0.55, lower than the global average of 0.59 (Berg et al. 2022), reflecting India-specific challenges like inconsistent disclosures.
- Standard deviation of scores ranged from 12 to 28 points (100-point scale), with governance scores showing the

highest variability (SD = 20.1), likely due to differing interpretations of board independence and related-party transactions.

Impact on Financial Outcomes:

Cost of Equity: A 10-point increase in ESG rating divergence raised the cost of equity by 0.18% ($\beta_1 = 0.018, p < 0.01$). This effect was stronger for mid-cap firms, where investor reliance on external ratings is higher.

Cost of Debt: Divergence had a marginal effect ($\beta_1 = 0.005, p = 0.15$), as Indian banks prioritize credit ratings over ESG metrics.

Firm Valuation: Higher divergence reduced Tobin's Q by 0.01 per 10-point increase ($\beta_1 = -0.010, p < 0.01$), indicating valuation penalties from conflicting signals.

Sectoral Variations: Divergence was pronounced in energy and manufacturing, where environmental scores varied due to differing weights on emissions versus renewable investments. IT firms showed lower divergence, reflecting standardized governance practices.

Robustness: Fixed-effects models confirmed results, though effect sizes were smaller for large-cap firms like Reliance, which benefit from robust disclosures.

Qualitative Findings

Thematic analysis identified four themes:

1. Investor Distrust: 80% of investors reported reduced confidence in ESG ratings, particularly FIIs accustomed to global standards. A mutual fund manager stated, "Divergent scores force us to second-guess sustainability claims, delaying investments."

2. Disclosure Gaps: Corporate managers highlighted uneven BRSR compliance, with mid-cap firms struggling due to resource constraints. Large firms, however, used disclosures strategically to influence ratings.

3. Cultural Misalignment: Analysts noted that global ESG frameworks undervalue India-specific factors, like community engagement, leading to skewed social scores.

4. Standardization Demand: All stakeholders supported harmonized metrics, with SEBI's BRSR seen as a foundation. However, analysts cautioned against overly rigid standards that ignore sectoral diversity.

4.3 Synthesis

Quantitative results confirm that ESG rating divergence undermines Indian capital market efficiency, raising equity costs and depressing valuations, especially for mid-cap firms. The lower correlation (0.55) compared to global benchmarks reflects India's nascent ESG ecosystem, where disclosures and methodologies are evolving. Qualitative insights reveal distrust and cultural mismatches as key drivers, exacerbated by resource disparities between large and smaller firms. The limited impact on debt costs suggests that Indian credit markets lag in ESG integration, a critical gap given rising green bond issuances (RBI 2023).

CONCLUSION

ESG integration is reshaping Indian capital markets, aligning investments with sustainability goals and global standards. However, ESG rating divergence undermines this progress, increasing costs of equity, depressing valuations, and eroding trust, particularly for mid-cap firms. This study's mixed-methods approach quantitative analysis of 200 firms and qualitative insights from 25 stakeholders reveals the scale of inefficiency and its roots in disclosure gaps and cultural misalignment. By proposing standardized frameworks, regulatory oversight, and capacity building, the paper offers a roadmap for enhancing market efficiency. As India aims to lead in sustainable finance, addressing rating divergence will be critical to ensuring that ESG drives equitable growth and investor confidence.

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