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Do ESG Rating Differences Weaken the ESG-Cost of Equity Link?

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ABSTRACT:

This thesis examines whether differences in ESG ratings across different providers weaken the relationship between ESG performance and the cost of equity. The topic is approached through a structured literature review of existing relevant literature combined with a theoretical synthesis. Company's ESG performance can affect the cost of equity through different channels and this thesis focuses on information, risk, and investor demand. Previous research in ESG and corporate finance generally finds that stronger ESG performance is associated with a lower cost of equity. The strength of this relationship varies across markets, time periods, and measurement methods. Studies on ESG ratings show that rating providers often disagree in their assessments of firms' ESG performance. Overall, the findings suggest that ESG performance tends to reduce the cost of equity on average but disagreement between ratings can weaken this effect by making ESG information less clear.

KEY WORDS: ESG, ESG ratings, rating disagreement, cost of equity, sustainability linked instruments, capital markets

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1 Introduction

ESG (environmental, social and governance) factors have become an increasingly relevant part of modern finance. Investors, regulators and firms now consider ESG performance alongside traditional financial metrics when evaluating corporate behaviour and risk. ESG information is now used in portfolio selection, risk assessment and engagement, and it plays a growing role in how firms communicate with the market (Amel-Zadeh & Serafeim, 2018; Friede et. al., 2015).

A key question in the literature is how ESG performance is related to the cost of equity. The cost of equity represents the return investors require for bearing a firm's risk. If ESG performance reduces information asymmetry or lowers exposure to adverse events, the firm may be seen as less risky, which can lead investors to accept a lower required return. Several empirical studies report a negative relationship between ESG performance and the cost of equity, suggesting that better ESG practices can translate into lower financing costs (Dhaliwal et al., 2011; El Ghoul et al., 2018).

Some studies report weak, mixed, or even opposite results, suggesting that the relationship is not yet fully understood. One explanation for these inconsistent findings relates to ESG ratings. ESG ratings combine different indicators into overall scores, which investors often use as proxies for a firm's sustainability performance. Rating providers differ in their choice of data, indicators and weighting methods. Because of these differences, the same firm can receive substantially different ESG ratings depending on the provider. Recent evidence shows that disagreement between ESG ratings is systematic and persistent, and that it may affect how investors interpret ESG information (Berg et al., 2022). This raises the question of whether rating differences weaken the link between ESG performance and financial outcomes such as the cost of equity.

This question is particularly relevant in the European context. European capital markets have introduced extensive regulation related to sustainable finance. Initiatives such as the Sustainable Finance Disclosure Regulation (SFDR) and the Corporate Sustainability Reporting Directive (CSRD) are intended to improve the quality, comparability and reliability of ESG information. Despite this, many investors and firms still to rely on private ESG ratings, which are not always aligned across providers. This makes it important to examine how rating differences affect the relationship between ESG performance and the cost of equity and what this implies for the credibility and usefulness of ESG metrics.

1.1 Purpose of the study

This thesis examines whether differences in ESG ratings weaken the relationship between ESG performance and the cost of equity. The analysis is based on a review of existing literature rather than new empirical tests using firm-level data. The study synthesises prior empirical findings and develops a theoretical framework linking ESG ratings, rating disagreement and the cost of equity. It then evaluates whether the existing literature supports this framework or points to conflicting evidence.

The thesis focuses on listed firms, because most empirical studies in this area rely on data from publicly traded companies, where ESG ratings and market based measures of the cost of equity are available. The literature covers both global and regional evidence, with particular attention to European markets. The analysis concentrates on ESG ratings provided by major commercial data providers, such as Refinitiv, MSCI and Sustainalytics. These ratings are commonly used in both academic research and in practice. The assessment is based on published academic studies and existing reviews of the ESG rating landscape, rather than on proprietary rating data.

Previous studies often find that firms with higher ESG ratings tend to have a lower cost of equity, as investors view them as more transparent and less risky (Dhaliwal et al., 2011; El Ghoul et al., 2018). This lead to the first hypothesis.

H1: Firms with higher ESG ratings have a lower cost of equity.

However, differences between ESG rating agencies can make ESG information less reliable. When rating providers such as Refinitiv and MSCI give inconsistent evaluations for the same firm, investors may find it harder to interpret ESG scores as signals of risk or quality (Berg et al., 2022). This lead to the second hypothesis.

H2: Greater differences between ESG rating providers weaken the relationship between ESG ratings and the cost of equity.

This thesis addresses these hypotheses by reviewing the existing empirical evidence on ESG, the cost of equity and rating disagreement, and by analysing whether the theoretical channels identified in the framework are supported by prior research.

1.2 Structure of the study

The remainder of this thesis is organised into five chapters. Chapter 2 presents the theoretical foundations in corporate finance and asset pricing that are relevant for the topic. The chapter begins with a discussion of the cost of equity and risk in standard asset pricing frameworks. It then reviews how information asymmetry and disclosure are linked to the cost of capital, how stakeholder theory and corporate responsibility relate to firm risk, and how investor preferences and market participation can influence expected returns.

Chapter 3 turns to ESG in corporate finance and capital markets. It first describes how ESG considerations have become part of corporate decision making and financial

analysis. The chapter then reviews empirical evidence on the relationship between ESG performance, firm value and financial performance. It then focuses more closely on studies that examine ESG and the cost of equity.

Chapter 4 focuses on ESG ratings and rating disagreement. It describes the main ESG rating providers and outlines their role in supplying ESG data to investors and researchers. The chapter then explains how rating methodologies differ across providers and how these differences give rise to rating divergence. It reviews how rating disagreement is measured in empirical research and reviews prior literature on its financial implications.

Chapter 5 concludes the thesis. It summarises the key insights from the theoretical and empirical literature, answers the research question at a conceptual level and discusses whether the evidence supports the hypotheses of the study. It outlines the main limitations of the thesis and suggests directions for future empirical research on ESG rating differences and the cost of equity.

2 Theoretical foundations in corporate finance and asset pricing

2.1 Cost of equity and risk in asset pricing

Cost of equity is the return that investors require for holding a firm's shares. It acts as the discount rate for future cash flows to equity holders and is therefore an important driver of firm value in standard valuation models (Brealey et al., 2019). In simple terms, the cost of equity reflects how risky investors think the firm is. If they see the firm as more risky, they will ask for a higher expected return.

Modern finance uses asset pricing models to describe the link between risk and expected return. The best known example is the capital asset pricing model, which connects the expected return of a stock to a risk free interest rate and to how strongly the stock tends to move with the overall market (Sharpe, 1964; Lintner, 1965).

$$k_e = r_f + \beta_i\big(E(R_M) - r_f\big)$$

where k_e indicates the cost of equity, r_f is the risk-free rate, $E(R_M)$ is the expected return on the market portfolio, and β_i measures the sensitivity of the firm's returns to market movements. The basic idea is that investors want extra compensation for holding assets that perform poorly when the market as a whole is doing badly.

In modern finance the total risk is typically divided into systematic and firm-specific components. Systematic risk reflects broader economic conditions, such as business cycles and unexpected shifts in financial markets. Firm specific risk is related to events that affect individual companies, for example product failures or isolated legal issues. In a well diversified portfolio the firm-specific risk can be largely eliminated, whereas systematic risk cannot. This is why asset pricing models place more emphasis on systematic risk when explaining expected returns (Brealey et al., 2019).

Later research extends this view by adding more risk factors. Fama and French (1993, 2015) show that characteristics such as firm size, value and profitability help explain differences in average stock returns in addition to broad market movements. In these multifactor models, the cost of equity depends on several types of risk and on how sensitive a stock is to each of them. The common message is that assets which are more exposed to unfavourable economic conditions tend to have higher required returns.

From a corporate finance perspective, the cost of equity plays a central role in both valuation and investment decisions. It is used as the discount rate in models that value equity cash flows and it forms part of the firm's weighted average cost of capital (WACC) together with the cost of debt (Brealey et al., 2019). A lower cost of equity reduces the hurdle rate for new projects and increases the present value of future cash flows. A higher cost of equity has the opposite effect and can make it more difficult for investments to meet the firm's return targets.

2.2 Information asymmetry, disclosure and the cost of capital

In capital markets, managers usually know more about a firm's prospects than outside investors. This difference in information is referred to as information asymmetry. When investors feel that they do not see the full picture, they face a higher risk that their valuation of the firm is wrong. As a result, they may demand a higher expected return to compensate for this uncertainty, which raises the firm's cost of equity.

Disclosure is one of the main tools for reducing information asymmetry. By providing more detailed and timely information, firms can narrow the gap between what managers know and what investors know. Theoretical models show that higher quality disclosure can improve the functioning of capital markets and lower required returns. Diamond and Verrecchia (1991) argue that greater public disclosure encourages informed trading to move from private to public information and improves liquidity. Better liquidity, in turn, lowers the expected return that investors require. Lambert, Leuz and Verrecchia (2007)

analyse how the quality of accounting information affects the cost of capital. They show that more precise information about a firm's future cash flows can reduce both the assessed risk of those cash flows and the covariances that enter into asset pricing, which leads to a lower cost of capital.

Empirical research supports these theoretical insights. Healy and Palepu (2001) review the disclosure literature and find that firms with more extensive and transparent reporting generally benefit from lower costs of capital and higher stock market valuations. Studies that look at changes in disclosure rules or voluntary disclosure often find that better disclosure is linked to lower expected returns. They also report narrower bid-ask spreads, which suggests lower information risk (Healy & Palepu, 2001; Lambert et al., 2007).

Healy and Palepu (2001) findings suggest that investors value credible and comparable information and that firms can influence their financing conditions through their reporting choices. Non financial reporting can play a similar role. In addition to traditional financial statements, many firms provide information on strategy, risks and other qualitative aspects of their business. Environmental, social and governance disclosures are part of this broader reporting environment. When firms explain how do they manage sustainability related issues, they give investors additional material for assessing long term prospects and potential risk exposures. Evidence from studies on voluntary corporate responsibility reporting indicates that firms which start to disclose such information may experience a reduction in their cost of equity, which is consistent with lower information risk and greater investor confidence (Dhaliwal et al., 2011).

2.3 Stakeholder theory, corporate responsibility and firm risk

Traditional finance models often treat shareholders as the main group whose interests the firm should maximise. Stakeholder theory takes a broader view. It argues that firms operate in a network of relationships with employees, customers, suppliers, creditors, regulators and local communities, and that long term success depends on how these relationships are managed (Freeman, 1984). If key stakeholders lose trust in the firm, they can withdraw support, which may disrupt operations and damage cash flows.

Well managed stakeholder relationships can reduce both the likelihood and severity of adverse events. Firms that invest in employee welfare and workplace safety may face fewer strikes, accidents, and disruptions to productivity. Attention to product quality and fair treatment of customers can also lower the risk of boycotts, lawsuits, and large-scale product recalls. Constructive engagement with regulators and local communities can lower the risk of fines, permit delays or conflicts over environmental impacts.

Empirical studies provide evidence that these mechanisms can influence the cost of capital. Sharfman and Fernando (2008) examine environmental risk management and find that firms with better environmental practices tend to have a lower overall cost of capital. Their results are consistent with the idea that managing environmental issues reduces perceived risk for investors. Lins, Servaes, and Tamayo (2017) study the global financial crisis. They find that firms with stronger social capital, measured by prior investments in corporate social responsibility, performed better during the crisis. They argue that trusted stakeholder relationships helped those firms maintain access to resources and preserve cash flows when uncertainty was high.

This discussion also extends to the systematic risk. Albuquerque, Koskinen and Zhang (2019) develop a model in which corporate social responsibility is treated as an investment in customer loyalty. In their framework, firms that succeed in building loyal customer bases face less elastic demand and enjoy more stable profit margins. This stability makes profits less sensitive to aggregate shocks and therefore reduces

systematic risk. Their empirical tests support this prediction, as firms with higher responsibility scores tend to have lower estimated betas and higher valuations. The results in their work imply that corporate responsibility can influence both cash flow volatility and also the component of risk that is priced in asset markets.

Strong ESG practices can reduce downside risk and exposure to broader market shocks when they improve stakeholder relationships and make severe negative events less likely. If investors view these effects as credible, they may accept a lower expected return. By contrast, responsibility initiatives that are mostly symbolic or poorly targeted are unlikely to reduce risk in any meaningful way (Albuquerque et al., 2019).

2.4 Investor preferences, market participation and expected returns

Asset pricing models typically assume that investors care only about risk and return. Some studies move away from this assumption and allow investors to have preferences for company characteristics. In this view some investors may be willing to sacrifice part of their financial return in order to avoid firms they see as harmful or to support firms they see as responsible.

Early theoretical work by Heinkel, Kraus and Zechner (2001) examines a setting where a group of “green” investors refuses to hold shares of polluting firms. When enough investors follow this exclusion strategy, the remaining investor base for polluting firms becomes smaller and more specialised. The model predicts that such firms face a higher cost of capital and that ”green” firms can enjoy a lower cost of capital, even if their cash flows are otherwise similar. Hong and Kacperczyk (2009) provide related empirical evidence using so called “sin stocks”, such as tobacco, alcohol and gambling companies. They find that these firms are held by fewer norm constrained institutions. As a result, they tend to earn higher average returns, which supports the idea that a smaller investor base leads to higher required returns.

More recent models include ESG preferences into modern asset pricing. Pastor, Stambaugh and Taylor (2022) develop a framework in which some investors did get direct benefit from holding sustainable companies. In their model, firms with better sustainability profiles can have lower expected returns, because investors are willing to accept a lower financial payoff in exchange for the non financial benefits they receive from owning such firms. Pedersen et al. (2021) analyse how both preferences and beliefs about ESG affect asset prices. Results show that “green” assets can trade at a premium when there is sufficient demand from ESG motivated investors. This also helps explain why firms seen as more sustainable may face a lower cost of equity, often described as a “greenium”.

3 ESG in corporate finance and capital markets

3.1 ESG in corporate finance

The value of strong ESG practices has become increasingly important in corporate finance. Large listed firms are more often expected to report on their sustainability performance, and many investors state that they incorporate ESG information into portfolio decisions. In practice, ESG information reaches capital markets through several channels. Firms publish sustainability reports, integrate ESG topics into annual reports and respond to surveys from data providers. Specialised rating agencies aggregate this information into ESG scores that investors and asset managers use in screening, ESG integration and engagement strategies. For companies this means that financing conditions no longer depend only on traditional financial indicators. How a firm manages environmental impacts, relationships with stakeholders and internal governance can also influence how outside investors view the firm.

From a corporate finance perspective ESG affects several key decisions. First, investment policy is shaped by how firms assess long term environmental and social risks and opportunities. Capital budgeting decisions may take into account, for example, expected carbon prices, regulatory changes or shifts in consumer preferences. Second, financing policy can be linked to ESG performance through access to capital markets. Firms that are perceived as responsible and well governed may find it easier to issue equity or debt and may face lower required returns from investors or lower spreads from lenders. Third, payout and ownership policies can be influenced by the preferences of large shareholders, such as institutional investors or state owners, who may have clear sustainability objectives (Dhaliwal et al., 2011; El Ghoul et al., 2018).

It is noteworthy to say that the academic literature reflects this increasing focus. Surveys and meta analyses that compare studies on corporate responsibility and financial performance generally find that the relationship is non negative and often positive

(Friede et al., 2015; Revelli & Viviani, 2015). These reviews cover both market based measures, such as stock returns and the cost of capital, and accounting based measures, such as profitability. The literature suggests that firms do not systematically reduce shareholder value by engaging in sustainability activities. But in many cases, responsible behaviour is associated with similar or slightly better financial outcomes.

3.2 Sustainability linked instruments

Sustainability-linked instruments mean debt contracts where the financial terms are tied to sustainability performance indicators. Typically the contract includes explicit sustainability contingencies, meaning that borrowing costs can change if the borrower meets or misses pre-defined ESG targets. Use-of-proceeds instruments are financial instruments, which restrict the financing to specific environmental or social projects. Unlike use-of-proceeds, sustainability-linked structures typically allow general corporate purposes while linking the price of capital to ESG-related metrics. This approach has become increasingly visible in corporate financing, especially in bank lending (Kim et al., 2025).

The first widely known suintainability linked instrument was a loan by ING Bank for Philips in 2017, where the interest margin was tied to the Philips' sustainability performance. Evidence from the global loan market states that sustainability-linked lending expanded rapidly after 2017, which is identified as a starting point for this market segment. Kim et al. (2025) document that sustainability-linked loans have been a major driver of the growth in ESG-contingent borrowing in private debt markets. At the same time, the authors emphasise that contracts differ substantially in how clearly they disclose their sustainability-related terms to external stakeholders. This is important because sustainability-linked labels can reflect either real commitment or superficial signalling, depending on how strict and transparent the contractual details are (Kim et al., 2025).

Sustainability-linked loans (SLLs) are general purpose loans where the spread is contractually tied to key performance indicators (KPIs). These indicators can be based on third-party ESG ratings or on measurable environmental and social metrics such as emissions or employee safety outcomes (Kim et al., 2025). A central concern in this market is transparency. Many SLLs do not publicly disclose the specific indicators or the pricing grids that determine how meeting targets changes the spread. In their analysis, Kim et al. (2025) classify loans based on the availability of publicly disclosed information and show that low-transparency loans are common. This creates room for weak incentives in practice, because external stakeholders may not be able to evaluate is the sustainability link actually meaningful (Kim et al., 2025).

This idea also applies to bond markets through sustainability-linked bonds (SLBs). In this bond segment, financial characteristics can change if the issuer fails to meet predefined sustainability performance targets linked to KPIs. In this scenario, the mechanism often takes the form of a coupon step-up (Shimauchi et al., 2025). This is conceptually different from corporate green bonds. With corporate green bonds, the defining feature is the restriction of proceeds to projects that address environmental challenges. Sustainability bonds and green bonds are both use-of-proceeds instrument. The difference is that in sustainability bonds proceeds can be directed to both environmental and social projects (Shimauchi et al., 2025). Sustainability-linked bonds differ from both, because the pricing mechanism is tied to performance targets rather than being anchored in a project budget (Shimauchi et al., 2025).

This distinction also matters in the ESG-cost of equity discussion, since sustainability-linked instruments are built around performance metrics. Their usefulness as signals depends on whether those metrics are seen as credible. If they are unclear, hard to verify, or not comparable, investors may be less willing to treat the sustainability linkage as evidence of lower risk or better governance. Research on labelled bond markets also shows that not all labelled structures are associated with similar improvements in environmental outcomes. The role of contract design and credibility is important when

ESG-linked financing is interpreted as a signal (Shimauchi et al., 2025). Differences in disclosure and metric choice across contracts is an broader issue that is closely related to this thesis. When ESG metrics are difficult to verify, or when data providers produce inconsistent assessments, ESG-related information may seem less reliable as an input in capital pricing (Kim et al., 2025).

3.3 ESG and firm value

One of the most common themes in ESG literature is how ESG performance is related to firm value and financial performance. The usual argument is that firms handling environmental, social and governance issues more responsibly may be in a better position to create long-term shareholder value.

Early research on corporate social performance and financial performance already found a connection between two. Margolis and Walsh (2003) review a large number of studies and report that most of them find a positive or at least non negative relationship between social initiatives and financial outcomes. Later meta analyses focusing on socially responsible investment and ESG reach similar conclusions. Friede, Busch and Bassen (2015) summarise more than two thousand empirical studies and find that the majority show a non negative, and often positive, link between ESG related measures and financial performance. Revelli and Viviani (2015) analyse socially responsible investment funds and conclude that they do not systematically underperform conventional funds. These reviews support to the hypothesis one, that ESG is generally compatible with, and in many cases beneficial for firm value.

Firm level studies provide more detailed evidence on specific settings. Velte (2017), for example, examines German listed companies and finds that higher ESG performance is associated with better financial performance, especially when governance quality is

strong. The strength of the relationship varies across countries, time periods and ways of measuring ESG, which indicates that context matters.

Krueger (2015) studies market reactions to corporate responsibility news and finds that investors react more strongly to negative events, such as environmental accidents or social controversies, than to positive announcements. This asymmetry suggests that avoiding poor ESG performance may be more important for firm value than achieving very high ESG scores. In other words, ESG may protect value primarily by reducing the likelihood and impact of severe negative outcomes, rather than by generating large upside gains. This can be linked to traditional behavioral finance theories such as propect theory and loss aversion. Kahneman & Tversky (1979) find that investors react more strongly to losses than to wins.

3.4 Empirical evidence on ESG and cost of equity

Many studies examine the relationship between ESG and firm value but there is a growing amount of research done that focuses specifically on the relationship of ESG and cost of equity. The main question in this reasearch is whether firms with stronger ESG performance face lower equity financing costs than comparable firms with weaker ESG profiles.

Several empirical papers report a negative association between ESG related measures and the cost of equity. Dhaliwal et al. (2011) study firms that initiate voluntary non financial disclosure and find that these firms experience a reduction in their implied cost of equity capital following the initiation. They interpret this pattern as evidence that additional ESG related information reduces information risk and increases investor confidence. El Ghoul et al. (2018) examine corporate environmental responsibility in an international sample and report that firms with stronger environmental performance tend to have lower costs of capital, including a lower cost of equity. Oikonomou, Brooks and Pavelin (2014) analyse social performance in the United Kingdom and show that

firms with better social responsibility scores face lower equity financing costs than firms with weaker performance. These studies are in line with the research H1 of this thesis, that higher ESG performance is often associated with a lower cost of equity .

The methods used to estimate the cost of equity differ across these papers, which is important for interpretation. Some studies, such as Dhaliwal et al. (2011), rely on implied cost of equity models based on analyst earnings forecasts and current stock prices. Others use factor based return models and interpret realised stock returns as reflecting expected returns over the sample period. Both of these approaches have advantages and limitations. Implied measures depend on the quality of analysts' forecasts and on the chosen valuation model, while return based measures are affected by return volatility and by the specification of risk factors. The fact that negative ESG-cost of equity associations appear under different methods nevertheless provides support for the idea that ESG can influence required returns.

Some studies find weak, statistically insignificant or mixed relationships between ESG performance and the cost of equity. Survey and meta-analytic work also reports huge variation in results across samples and methods (Friede et al., 2015; Revelli & Viviani, 2015). Differences in research design, sample period, region and ESG measurement contribute to this variation. For example, results can depend on whether the analysis focuses on overall ESG scores, on specific environmental or social pillars, or on individual responsibility indicators. The way in which control variables are specified and the extent to which industry and country effects are taken into account can also influence estimated coefficients. Ng and Rezaee (2015) analyse corporate social responsibility and the cost of capital and highlight that findings are sensitive to model specifications and to how CSR is measured.

Despite these differences, the pattern that emerges from the literature is broadly consistent with the research H1 of this thesis. Many studies document that firms with stronger ESG or corporate responsibility profiles have a lower implied or realised cost of

equity, and the theoretical channels related to information, risk and investor demand offer plausible explanations for this pattern. But this relationship is not confirmed in all settings. The strength of the effect varies across markets, time periods and measurement choices, and some papers find insignificant or no association.

This mixed evidence opens the door for additional explanations. One potential factor is how ESG performance is measured in the first place. Most empirical studies rely on ESG ratings from commercial data providers, yet these ratings often disagree with each other. If the underlying ESG signal is noisy or inconsistent across providers, estimated links between ESG scores and the cost of equity may be weaker or less stable than they would be under a clear and uniform measure. This raises focus on research hypothesis two.

4 ESG ratings and ratings disagreement

4.1 ESG rating providers

ESG rating providers collect and aggregate information on firms' ESG practices and convert it into summary assessments. The ratings are intended to capture how well a company manages sustainability related risks and opportunities. These ratings are widely used by investors, asset managers and researchers as convenient indicators of ESG performance. Large global providers include MSCI, Refinitiv (part of LSEG) and Sustainalytics, alongside several regional and specialised agencies. Some of these providers have their roots in earlier corporate social responsibility or ethical investment research and have gradually expanded their coverage and methodologies as investor interest in ESG has grown.

The major providers rely mainly on publicly available information, such as annual reports, sustainability reports, regulatory filings and news flows, and in some cases on company questionnaires and other third party databases (MSCI, 2023; LSEG, 2024; Sustainalytics, 2024). Their clients use ESG ratings in several ways. They may rely on them as screening tools, treat them as inputs into ESG integration and engagement strategies or use them as benchmarks for products such as SLLs and funds. These ratings are used in a wide range of investment processes and they play an important role in how sustainability considerations enter capital markets.

In addition to the large global agencies, there are smaller providers that focus on particular regions, themes or asset classes. Some firms specialise in European markets or in specific industries, while others concentrate on second party opinions for labelled bonds or on controversies and incident tracking. These specialised providers often cater to investors with more targeted information needs, for example those interested in climate risks, human rights issues or governance quality in a particular region. These providers market share is smaller than that of the largest agencies but they contribute

to the diversity of available ESG assessments. This is important, because ESG rating industry is heterogeneous and still evolving.

4.2 ESG rating methodologies

Many ESG rating agencies share a similar goal but their methodologies differ in important respects. Each provider defines its own set of indicators, industry classifications and aggregation rules. In practice this means that a firm's ESG rating reflects many design choices, including which topics are treated as material in each sector, how qualitative information is coded into numerical scores and how separate indicators are combined into pillar scores and overall ratings. Some providers place more weight on policies and management systems, while others focus more on realised outcomes or controversies. Methodology documents published by major providers and comparative academic studies both report substantial variation in these choices, and there is no single standard that would align them across the industry (Berg et al., 2022).

Prior research has highlighted three broad sources of methodological differences across ESG raters. Berg et al., (2022) refer to these as scope, measurement and weights. Scope differences arise when providers include different topics, apply different industry classifications or cover different universes of firms. Measurement differences occur when the same underlying issue is captured with different indicators, data sources or coding rules. Weight differences reflect how much importance each provider assigns to individual indicator and pillar when calculating the final score.

Earlier work on social and responsibility ratings already documented that agreement across raters is often limited. Chatterji et al., (2016) show that several well established social rating providers produce only modestly correlated assessments of corporate responsibility. More recent reviews of ESG ratings reach similar conclusions. They argue that rating divergence is a widespread and persistent feature of the ESG data landscape,

driven by differences in methodology and data choices and with potential implications for investment decisions (Berg et al., 2022).

4.3 Rating disagreement sources and measurements

Rating disagreement refers to the extent to which different ESG rating providers give the same firm different scores. Even when providers aim to evaluate similar sustainability dimensions, their assessments often diverge. This disagreement is not just random noise. It reflects the methodological choices described in the previous section and can be systematic across firms, industries and time (Berg et al., 2022; Chatterji et al., 2016).

Several studies document that disagreement between ESG ratings is substantial. Berg et al. (2022) show that correlations between major ESG providers are far from perfect and that a significant share of the variation in ratings can be traced back to differences in scope, measurement and weights. Chatterji et al. (2016) find similar patterns for earlier social and responsibility ratings, suggesting that disagreement is a persistent feature of third party evaluations of corporate responsibility.

In empirical research, rating disagreement is measured in different ways. A common approach is to take the simple difference between the scores of two providers for the same firm and year, often using absolute values to focus on the magnitude of disagreement rather than its direction. When more than two providers are available, researchers may calculate the dispersion or standard deviation of ratings across providers. Gibson Brandon et al. (2021), for example, use the standard deviation of standardised ESG scores across several raters to measure disagreement. Rank based measures are also used, such as the distance between a firm’s ranking under one provider and its ranking under another. Each of these measures captures a slightly different aspect of disagreement, but they all reflect how far apart providers are in their assessment of the same firm.

The choice of measurement can matter for interpretation. Differences in levels or ranks can be influenced by how providers scale and normalise their scores. To address this, many studies use transformed or standardised ratings, for instance by converting scores into industry adjusted z scores before computing disagreement measures (Berg et al., 2022; Gibson Brandon et al., 2021). Researchers also differ in whether they analyse disagreement at the overall ESG level or separately for environmental, social and governance pillars. Outcome of ratings give a general view of disagreement, while pillar-level measures help show which ESG areas are most debated and where rating methods differ the most.

It seems like the rating disagreement is a systematic and measurable phenomenon rather than a minor technical detail (Berg et al., 2022; Gibson Brandon et al., 2021). It reflects genuine differences in how providers interpret corporate behaviour and assign importance to various ESG issues. These ratings are widely used by investors and researchers, so disagreement between them matters. Before discussing its financial implications, it is first necessary to consider why this disagreement arises and how it is measured.

4.4 Financial implications of rating disagreement

Rating disagreement is not only a methodological issue. It also has financial implications, because many investors and products rely on ESG ratings when forming portfolios. When different providers disagree on a firm's ESG performance, investors receive mixed signals about that firm's sustainability profile. This can affect how ESG information is incorporated into prices and how capital is allocated across firms.

Gibson Brandon et al. (2021) analyse stock returns in the presence of ESG rating disagreement and find that firms with higher disagreement face higher risk premia and higher average returns. Their results suggest that markets react differently when ESG information is noisy or conflicting. In these cases, some investors may choose to ignore

ESG ratings, while others may even use disagreement itself as a signal about risk or mispricing. This means that the rating disagreement can shape both risk perceptions and trading strategies.

Disagreement also affects how ESG information contributes to risk assessment. If ESG ratings are intended to summarise exposure to sustainability related risks, conflicting assessments can make it harder for investors to evaluate those risks. Reviews of ESG reporting and disclosure note that investors often emphasise the importance of reliable and comparable sustainability information for assessing risk and valuation (Amel-Zadeh & Serafeim, 2018; Christensen et al., 2021).

From a cost of capital perspective, rating disagreement can influence both the level and the dispersion of required returns. If investors cannot agree on a firm's ESG quality, they may arrive at different assessments of its risk and long term prospects. Some investors may demand a higher return to compensate for the additional uncertainty created by conflicting information, while others may be willing to accept a lower return if they trust a particular provider. In models with heterogeneous beliefs and preferences, such differences in assessments naturally lead to dispersion in required returns and risk premia (Miller, 1977; Pastor et al., 2022).

Measurement issues provide an additional channel through which disagreement affects financial results. When researchers use ESG ratings as explanatory variables, disagreement across providers implies that the chosen rating contains measurement error relative to any underlying true ESG performance. In standard econometric analysis, classical measurement error in explanatory variables typically biases estimated coefficients toward zero and reduces statistical significance (Wooldridge, 2010). This is the core of research hypothesis 2 which is build on the idea that large differences in ESG ratings can weaken the observed relationship between ESG performance and the cost of equity. Even when ESG performance genuinely lowers the cost of equity, rating disagreement may make the estimated effect appear smaller and less precise.

5 Conclusions

This thesis reviews and synthesises prior literature to assess whether ESG rating differences may weaken the relationship between ESG performance and the cost of equity. More closely, what causes the differences between ESG ratings and is there even a link between them that it effects. The analysis is based on a structured review of existing literature and on a theoretical framework that links ESG performance, rating disagreement and the cost of equity through information, risk and investor demand channels. The thesis has synthesised prior studies and organised them around two hypotheses. The first hypothesis states that firms with higher ESG ratings have a lower cost of equity. The second hypothesis states that greater differences between ESG rating providers weaken the relationship between ESG ratings and the cost of equity.

The literature on ESG and corporate finance suggests that ESG performance is often, but not always, associated with favourable financial outcomes. Several studies find that firms with stronger ESG profiles tend to face lower equity financing costs, which is consistent with the idea that better ESG performance reduces information asymmetry, mitigates risk and attracts a broader investor base. At the same time, there are studies that report weak or insignificant relationships, and meta analyses emphasise the heterogeneity of results across contexts and measurement choices.

The review of ESG ratings and rating disagreement shows that diversity across providers is substantial and systematic. ESG ratings differ because providers make different choices about which issues to include, how to measure them and how to aggregate indicators into scores. Work on responsibility ratings and more recent studies on ESG ratings also document that correlations between providers are far from perfect and that disagreement can influence how investors interpret and use ESG information. These support the second hypothesis that when rating disagreement is high, ESG signals become noisier and investors may be less willing to adjust required returns based on ESG information.

On this basis, the thesis concludes that higher ESG performance is likely to be associated with a lower cost of equity, but that the strength of this relationship depends on how ESG is measured and on the degree of rating disagreement. The first hypothesis is broadly consistent with the empirical evidence, although the effect is not equally strong in all settings. The second hypothesis is supported at a conceptual level by the documented existence of rating disagreement and by its observed financial implications. Direct empirical tests of the interaction between ESG ratings, rating disagreement and the cost of equity remain limited. For future research, this thesis suggests that they should study combine cost of equity estimates with data from multiple ESG rating providers. Issues mentioned in this thesis are likely to remain a central challenge for researchers, investors, firms and regulators as ESG continues to be integrated more into capital markets.

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Appendix

Appendix 1. Statement on the use of AI-Assisted Technologies in the writing process

This thesis used AI-assisted tools in a limited and supportive role during the writing process. The language model used was OpenAI ChatGPT (GPT-5).

AI assistance was used for outlining the overall structure of the thesis and improving the logical flow between sections, helping to paraphrase and translate selected passages for drafting purposes, supporting the comparison and synthesis of ideas across sources, suggesting alternative wording and improving clarity, grammar, and academic style.

All decisions concerning the scope of the thesis, the interpretation of the literature, the formulation of hypotheses, and the conclusions are solely the author's own. AI-generated text was not inserted into the thesis. The author is fully responsible for the accuracy of the text, the appropriate use of sources, and compliance with academic integrity requirements.