

Research on the Impact of ESG Rating Divergence on Financial Markets

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Abstract: This study explores the multifaceted impacts of Environmental, Social, and Governance (ESG) rating divergence on financial markets, focusing on both equity and bond markets. Despite the growing importance of ESG criteria in investment decisions, discrepancies in ESG ratings—stemming from varying methodologies, standards, and data quality—pose significant challenges. We analyze how these divergences affect corporate reputations, influence investor behavior, and consequently, impact market volatility, funding costs, and liquidity. Our findings indicate that ESG rating discrepancies can lead to increased funding costs, heightened market volatility, and reduced market liquidity, all of which contribute to increased uncertainty for investors. The study suggests that the resolution of these issues requires the harmonization of ESG standards, enhanced regulatory oversight, and greater transparency in rating methodologies. Through comprehensive analysis, this paper contributes to understanding the implications of ESG rating divergence and proposes actionable strategies for stakeholders to mitigate its adverse effects, thereby fostering a more stable and transparent market environment.

Keywords: ESG, Rating Divergence, Financial Market, Stock, Bond.

1. Introduction

In today's global economy, environmental, social and governance (ESG) concepts are increasingly becoming an important yardstick to measure the sustainable development of enterprises. As investors pay more attention to social responsibility and long-term value creation, ESG construction has become an indispensable part of enterprises. However, as a key evaluation mechanism in this field, there are internal differences within ESG ratings that cannot be ignored: the differences in standards, emphases and methodologies adopted by different rating agencies may lead to completely different rating results for the same company under different evaluation systems. This rating divergence not only reflects the complexity and diversity of ESG evaluations, but also casts a shadow of uncertainty on the financial markets.

Studying the impact of ESG rating divergence on financial markets aims to uncover the underlying logic behind this phenomenon and its potential impact on investor decision-making, capital flows, and even market stability. With the popularization of ESG investment concepts, rating divergence may exacerbate the asymmetry of market information and affect investors' risk judgment and asset allocation strategies. Therefore, an in-depth discussion on the causes and manifestations of ESG rating divergence and its multi-dimensional impact on the financial market is not only of theoretical

value, but also of great significance for guiding practice and promoting the healthy development of the financial market.

Starting from the basic situation of ESG ratings, this article will systematically sort out different rating systems and standards, and then deeply analyze the root causes of rating divergence and its manifestations. The article will then focus on how ESG rating divergence can have a profound impact on financial markets by influencing mechanisms such as investor behavior, capital allocation efficiency, and market stability. Finally, based on the research conclusions, targeted policy suggestions and coping strategies are put forward to provide reference and enlightenment for relevant stakeholders.

2. ESG Rating and its Divergence

2.1. Basic Information of ESG Rating

As a key tool to measure the sustainability of enterprises, the ESG rating system has been widely used around the world. At present, there are a number of well-known ESG rating agencies in the market, such as MSCI, Sustainalytics, Morningstar, etc., each of which has built a unique rating framework and standard. Although these systems share the same core principles, i.e., focus on the performance of companies in the three dimensions of environmental, social and governance, there are significant differences in the selection of specific indicators, weight allocation and scoring methods [1].

In China, with the gradual popularization of ESG concepts, the local ESG rating system has also developed rapidly. The China Securities Regulatory Commission, stock exchanges and third-party institutions have launched their own ESG evaluation standards and guidelines, aiming to guide listed companies to strengthen ESG management and enhance their sustainable development capabilities. While drawing on international experience, these standards fully consider the particularity of the Chinese market and the actual situation of enterprises and form an ESG evaluation system with Chinese characteristics [2].

2.2. ESG Rating Divergence

The root cause of ESG rating divergence is the difference in evaluation philosophy, methodology, and data acquisition between different rating agencies [3]. First of all, the differences in evaluation concepts lead to different focuses of various institutions in the three dimensions of environmental, social and governance, some pay more attention to the environmental protection investment and effectiveness of enterprises, and some pay more attention to the implementation of corporate social responsibility or the optimization of governance structure.

Second, differences in methodology are also important reasons for rating divergence. Different institutions have their own advantages in index selection, weight allocation, data processing, and scoring rules, which makes it possible for the same company to receive completely different scores under different systems. In addition, differences in data access and quality are also factors that cannot be ignored. Compared with traditional financial data, the collection and collation of ESG data is more complex, involving a wide range of information, a large amount of information, and a low degree of standardization. The inconsistency of rating results is further exacerbated by the differences in data collection channels, coverage, and update frequency between different rating agencies [4]. The existence of ESG rating divergences has had a profound impact on financial markets. On the one hand, it makes it more difficult for investors to obtain effective information, which may lead to bias in investment decisions. On the other hand, it also prompts companies to pay more attention to the comprehensiveness and transparency of their ESG management, so as to strive for good reviews under different rating systems. However, how to balance the differences between different rating agencies

and establish more unified, fair and transparent ESG evaluation standards is still an urgent problem to be solved [5].

3. Impacts on Financial Markets

3.1. Stock Markets

First, ESG rating divergence can significantly impact a company's reputation and financing costs. When different rating agencies give very different ESG scores to the same company, investors and stakeholders may be skeptical about a company's sustainability practices. This inconsistency can weaken a company's image in the public eye, which in turn can affect its brand value. According to research, high-quality ESG performance helps companies build a good corporate image and attract more investors and customers [6]. However, rating divergences can lead to confusion and prevent companies from fully demonstrating their ESG strengths. When it comes to fundraising, investors typically place higher valuations and lower financing costs for companies with strong ESG performance. But when there is a rating divergence, investors may increase the risk premium, leading to higher funding costs for the company. In summary, ESG rating divergences have had a negative impact on the stock market by damaging a company's reputation and increasing the cost of financing [7].

Second, divergence in ESG ratings can lead to increased market volatility. Rating divergence causes market participants to diverge in their assessments of a company's value, leading to inconsistencies in trading behavior. According to financial theory, when the market's expectations for a company's future performance are inconsistent, both volume and price volatility increase [8]. The research shows that information asymmetry and inconsistent evaluation criteria are important reasons for market volatility. Investors may experience mood swings when faced with different ESG ratings, leading to overreaction or short-term speculation. This emotional trading behavior can further amplify the volatility of the market. In addition, rating divergence may trigger a lack of investor confidence in the market as a whole, increasing systemic risk. As a result, ESG rating divergences increase market volatility by influencing investors' psychological expectations and behaviors, causing shocks to the stock market [9].

Finally, divergence in ESG ratings increases the uncertainty of investors' decision-making. Investors rely on ESG ratings to assess a company's long-term sustainability and risk level. When different rating agencies give different ratings to the same company, it may be difficult for investors to judge the true ESG performance of the company. This information inconsistency can lead to investors being stuck in decision-making, which can lead to delays in investing or avoiding the underlying stock [10]. Some studies have pointed out that increased uncertainty can lead to increased risk aversion among investors, which may reduce investment activity and reduce market liquidity. In addition, investors may need to spend more time and resources to collect and analyze information, increasing the cost of decision-making. This psychological burden and behavioral changes can ultimately negatively impact the activity and efficiency of the stock market. In summary, ESG rating divergence has had a knock-on to equity markets by increasing uncertainty in investor decision-making [11].

In summary, ESG rating divergence has impacted the stock market through a variety of channels. It affects the company's reputation and the cost of financing, leading to increased market volatility and increasing uncertainty in investor decision-making. These effects not only have adverse consequences for individual companies, but also pose a challenge to the stability and healthy development of the entire market. To mitigate these shocks, regulators and rating agencies need to work to harmonize ESG rating standards and improve the transparency and reliability of the rating process. At the same time, companies should also actively disclose ESG information, enhance

communication with investors, and reduce information asymmetry. Only in this way can we promote the sustainable development of the stock market and give full play to the positive role of ESG investment.

3.2. Bond Markets

First, ESG rating divergence can lead to fluctuations in issuers' funding costs. Rating divergence leads investors to have different perceptions of the issuer's sustainability performance, which in turn influences their investment decisions. According to research, companies with higher ESG ratings are often able to issue bonds at lower interest rates because investors perceive them as less risky and more stable in the long term [12]. However, when different rating agencies give very different ratings on the ESG performance of the same issuer, investors may demand a higher risk premium to compensate for the uncertainty, resulting in higher financing costs for the issuer. On the other hand, some investors may reduce their confidence in the issuer due to rating divergence, reduce investment or divest, further exacerbating the volatility of funding costs. In summary, ESG rating divergence has an impact on the bond market by affecting investors' risk assessment and confidence, leading to fluctuations in issuers' financing costs [13].

Second, divergence in ESG ratings adds to the uncertainty of bond pricing. Bonds are typically priced based on the issuer's credit risk and market expectations. When ESG ratings diverge, it is difficult for investors to accurately assess the long-term risks and returns of issuers, which makes bond pricing more complex. The study found that the inconsistency of ESG information can lead to the repricing of risk in the market, increasing the volatility of bond yields, as information asymmetry and uncertainty will lead to market pricing deviation from its fundamental value. Investors may adopt a conservative investment strategy in the face of rating divergence, demanding higher yields to compensate for potential risks. This behavior further exacerbates uncertainty in bond pricing. It can be seen that ESG rating divergence has increased uncertainty in bond pricing by increasing information asymmetry, which has an impact on the bond market [14].

Finally, divergent ESG ratings have led to a decrease in liquidity in the bond market. Market liquidity is an important indicator of the health of the market, and high liquidity means that investors can easily buy or sell assets without affecting the price. When there is a divergence in ESG ratings, investors may take a wait-and-see approach to certain bonds, reducing trading activity. Some studies have shown that information uncertainty can reduce market participation, leading to a decline in trading volumes. In addition, institutional investors may adjust their portfolios and reduce their allocation to underlying bonds when faced with rating divergence, further reducing market liquidity. The decline in liquidity not only increases transaction costs but may also trigger large price fluctuations and affect the stability of the market. In summary, ESG rating divergence has had a negative impact on the market by influencing investors' trading behavior, leading to a decrease in liquidity in the bond market [15].

In summary, the ESG rating divergence has had a significant impact on the bond market. It leads to fluctuations in issuers' funding costs, increases uncertainty in bond pricing, and triggers a decline in liquidity in the bond market. These effects are mainly achieved by influencing investors' psychological expectations and behavioral decisions. To mitigate these shocks, rating agencies should strive to improve the transparency and consistency of their rating methodology, and issuers should actively disclose ESG-related information and enhance communication with investors. At the same time, regulators can consider formulating unified ESG rating standards to reduce information asymmetry and promote the healthy and stable development of the bond market.

4. Possible Solutions

4.1. Harmonization of Standards

Promoting the standardization of ESG ratings is the primary measure to resolve rating differences. Specifically, international organizations, regulators or industry associations should take the lead in establishing a unified ESG rating framework and indicators. This means developing a set of widely recognized rating standards on a global scale, allowing rating agencies to assess under a single framework. In addition, standardizing the rating methodology is key. Clearly stipulating the assessment methodology and weights that should be used by rating agencies, reducing subjectivity and methodological differences, can greatly improve the comparability and consistency of rating results [16]. Through these measures, rating divergence will be effectively reduced, and investors' trust in ESG ratings will be increased, which will contribute to the accuracy of investment decisions.

4.2. Strengthen Industry Supervision

Strengthening regulation and industry self-discipline is another important way to resolve ESG rating divergence. Regulators should issue normative documents for ESG rating business to clarify the responsibilities and compliance requirements of rating agencies. This will set clear operational standards for rating agencies to prevent irregularities from occurring [17]. At the same time, industry associations can promote self-regulatory norms, and rating agencies commit to abide by uniform professional ethics and evaluation standards by signing self-discipline conventions. This two-pronged approach will help standardize the order of the rating market and enhance the professionalism and credibility of rating agencies. In addition, strengthening regulation and self-regulation can protect investors' interests, prevent market manipulation and misleading information caused by rating differences, and ensure market fairness and transparency [18].

4.3. Enhance Institutional Transparency

Finally, enhancing the transparency of rating agencies is also a key measure to address rating divergence. Rating agencies should disclose their rating methodologies and models, disclosing rating methodology, index weights and model assumptions. This allows investors and issuers to better understand the basis of the rating results and increase confidence in the rating results. In addition, the rating agency should also disclose the interests that may affect the rating results to ensure the objectivity of the rating. This increased transparency not only enhances the credibility of the ratings, but also helps to build the market's trust in the rating agencies. A transparent rating process that allows all parties to participate in monitoring contributes to a healthy and orderly rating market environment [19].

In summary, the challenges posed by ESG rating divergence can be effectively addressed by promoting the standardization of ESG ratings, strengthening regulatory and industry self-discipline, and improving the transparency of rating agencies. These measures complement each other and work together to promote the healthy development of the rating market, protect the interests of investors, and enhance market trust, thereby laying a solid foundation for the development of sustainable finance.

5. Conclusion

This study explores the impact of ESG rating divergence on equity and bond markets, and three measures to address these shocks. The research first analyzes the impact of ESG rating divergence on the stock market from three aspects, including the impact on corporate reputation and financing costs, the increase in market volatility, and the increase in uncertainty in investors' decision-making.

Subsequently, the impact of ESG rating divergence on the bond market is studied, which is manifested in the fluctuation of issuers' financing costs, the uncertainty of bond pricing, and the decline of market liquidity. Finally, in response to the above problems, three countermeasures are proposed: promoting the standardization of ESG ratings, strengthening supervision and industry self-discipline, and enhancing the transparency of rating agencies. The main conclusion is that ESG rating divergence has a multifaceted negative impact on capital markets by influencing investors' psychological expectations and behavioral decisions. These impacts include increased funding costs, increased market volatility, reduced market liquidity, and increased uncertainty for investors. These problems are mainly due to the lack of unified standards and methods among rating agencies, which leads to information asymmetry and a decline in market trust.

Looking ahead, the importance of ESG ratings will rise further as the global focus on sustainability continues to increase. To address the challenges posed by rating divergence, all parties need to work together. First of all, it is key to promote the standardization of ESG ratings, with international organizations, regulators or industry associations taking the lead in establishing a unified rating framework and indicators, standardizing rating methods, and reducing subjectivity and methodological differences. Second, strengthen supervision and industry self-discipline, promote self-discipline through the formulation of guidelines by regulators and industry associations, and enhance the professionalism and credibility of rating agencies. Finally, the transparency of rating agencies should be strengthened, rating methods and models should be made public, conflicts of interest should be disclosed, and the credibility of ratings should be enhanced. Through the implementation of these measures, it is expected to effectively reduce ESG rating divergence, enhance the market's trust in the rating results, and promote the accuracy of investment decisions and market stability. At the same time, it will also help protect the interests of investors, prevent market manipulation and misleading information, and promote the healthy development of the capital market. In the future, as more market participants join the ranks of promoting the standardization and transparency of ESG ratings, the capital market is expected to achieve sustainable and high-quality development.

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