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ESG Performance and the Cost of Equity Capital: A Review of Evidence with Special Reference to India

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Abstract

Environmental, Social and Governance (ESG) considerations have increasingly become part of corporate financial decision-making and investor assessment. One important question is whether better ESG performance enables firms to obtain equity finance at a lower cost. Existing research, however, does not provide completely uniform findings. Several studies argue that strong ESG performance and disclosure reduce information asymmetry, improve corporate reputation, lower perceived risk and attract a wider investor base, thereby reducing the cost of equity. Other studies suggest that excessive ESG expenditure, agency problems, greenwashing and disagreement among ESG rating agencies can increase uncertainty and financing costs. This paper reviews the theoretical and empirical literature on the relationship between ESG and the cost of equity, with particular emphasis on India. The review indicates that recent evidence increasingly supports a negative ESG-cost of-equity relationship, although the magnitude and direction depend on ESG dimensions, disclosure quality, institutional environment, industry characteristics and rating methodologies. The paper concludes that credible and standardized ESG reporting is particularly important in emerging markets such as India.

Keywords: ESG, cost of equity, sustainability, ESG disclosure, information asymmetry, ESG ratings, India

1. Introduction

Environmental, Social and Governance considerations have moved from the margins of corporate reporting toward the centre of investment and financing decisions. Investors increasingly consider not only profitability and conventional financial ratios but also environmental exposure, labour practices, corporate governance, sustainability strategy and other non-financial information when assessing firms. Consequently, ESG performance can potentially influence how investors perceive corporate risk and, therefore, the return they require for holding a firm's shares.

The **cost of equity capital** represents the rate of return expected by shareholders for bearing the risks associated with investing in a company. From the firm's perspective, a lower cost of equity makes equity financing relatively less expensive and can increase the number of investment projects capable of creating shareholder value. ESG can influence this required return because sustainability-related information changes investors' perceptions concerning business risk, information quality, reputation and future cash-flow uncertainty. Earlier international research has therefore examined corporate responsibility and sustainability as possible determinants of firms' equity financing costs.

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The relationship nevertheless remains theoretically ambiguous. ESG activities can act as a signal of better management and lower long-term risk, but they can also be perceived as costly investments that do not necessarily generate corresponding financial benefits. Moreover, differences in ESG definitions and measurement have created additional uncertainty. Berg, Kölbel and Rigobon (2022), for example, show that ESG ratings from different providers can diverge substantially because agencies differ in what they measure and how they measure it. Christensen, Serafeim and Sikochi (2022) similarly find substantial disagreement among ESG rating agencies and show that increased ESG disclosure does not automatically eliminate this disagreement.

India represents a particularly important setting for examining these issues. SEBI made Business Responsibility and Sustainability Reporting (BRSR) mandatory for the top 1,000 listed companies by market capitalization from FY 2022-23. The reporting framework seeks standardized and quantitative ESG disclosures that facilitate comparison across companies, sectors and time. SEBI subsequently introduced the BRSR Core framework and has also developed a regulatory framework for ESG Rating Providers. These developments have increased both the quantity and regulatory importance of sustainability information in Indian capital markets.

Against this background, this paper reviews the literature concerning ESG performance, ESG disclosure and the cost of equity, with special emphasis on evidence from India.

2. Objectives of the Study

The study seeks to:

1. examine the theoretical mechanisms through which ESG may influence the cost of equity;
2. review major international and Indian empirical findings on the ESG-cost of equity relationship;
3. identify the reasons for conflicting findings in the existing literature; and
4. identify research gaps and implications for corporations, investors and policymakers in India.

3. Research Methodology

The study follows a **narrative literature-review methodology** based entirely on secondary sources. Peer-reviewed journal articles dealing with ESG performance, ESG disclosure, corporate social responsibility, sustainability, cost of equity, cost of capital, information asymmetry, ESG rating disagreement and related concepts were reviewed. Particular attention was given to studies directly examining the Indian capital market, while major international studies were incorporated to develop the theoretical foundation and enable comparison.

The review incorporates foundational literature as well as recent research published through 2025-26. Academic evidence was identified from publisher databases and journal platforms including Elsevier/ScienceDirect, Sage, Wiley and the American Accounting Association, while the contemporary Indian regulatory environment was examined using official SEBI documents. As this is a short student-level narrative review rather than a systematic review or meta-analysis, the objective is to synthesize major findings and debates rather than claim exhaustive coverage of every publication in the field.

4. Theoretical Relationship between ESG and Cost of Equity

4.1 Information Asymmetry and Signalling

One of the strongest arguments for a negative relationship between ESG and cost of equity arises from **information asymmetry**. Managers possess substantially more information regarding the firm's operations, risks and prospects than outside investors. When investors face greater uncertainty, they may demand a higher expected return as compensation. ESG disclosure can provide additional non-financial information concerning environmental risks, employee relations, governance quality and long-term strategy, thereby improving the information available to shareholders.

Dhaliwal et al. (2011) found that firms initiating CSR reporting with strong social performance subsequently experienced reductions in the cost of equity and attracted greater analyst and institutional-investor attention. The result suggests that credible non-financial disclosure can improve the corporate information environment rather than merely serve a public-relations function.

More recent evidence strengthens this mechanism. Li et al. (2024), using Chinese listed companies, found that ESG ratings reduced the cost of equity capital and identified reductions in information asymmetry and operational risk as important transmission channels. Consequently, ESG information can function as a signal that allows investors to evaluate companies with greater confidence.

4.2 Risk Reduction and Reputation

The second explanation concerns corporate risk. Strong environmental practices may reduce regulatory, legal and transition risks, while stronger social policies can reduce labour disputes and reputational damage. Effective governance can reduce managerial misconduct and agency problems. If these characteristics reduce uncertainty surrounding future earnings and cash flows, shareholders may accept a lower required return.

El Ghoul et al. (2011), using a large sample of US firms, found that companies with better CSR scores had lower equity financing costs. Responsible employee relations, environmental policies and product strategies were particularly important. Ng and Rezaee (2015) similarly found an overall negative association between sustainability performance and cost of equity, although the strength of the relationship differed across sustainability dimensions.

The importance of avoiding negative ESG events is demonstrated from another direction by Becchetti et al. (2023). Their study shows that corporate environmental, social and governance misconduct increases the cost of equity because such incidents create reputational risks that are relevant to shareholders. ESG therefore appears capable of affecting financing costs through both positive sustainability performance and the avoidance of damaging ESG controversies.

4.3 Investor Preference and the Investor Base

ESG may also influence financing costs through investor preferences. If institutional and individual investors increasingly prefer companies with credible sustainability characteristics, high-ESG companies may attract a larger pool of potential shareholders. Greater demand for their securities can contribute to favourable financing conditions. El Ghoul et al. (2011) connect responsible corporate practices with a broader investor base and lower perceived risk, while recent research in emerging markets similarly indicates that ESG characteristics can become relevant to asset pricing.

Thus, sustainability can affect the cost of equity even when its immediate accounting benefits are difficult to observe. Investors may value ESG because it contains information about long-term resilience, regulatory exposure and management quality.

5. Why ESG May Increase the Cost of Equity

The positive relationship proposed in some studies is equally important. ESG initiatives require financial and organisational resources. If shareholders believe managers are overinvesting in environmental or social activities for reputation or personal objectives rather than shareholder value, ESG expenditure can generate agency concerns. This perspective becomes particularly relevant when the economic returns from sustainability investments are uncertain.

Early evidence already demonstrated that social disclosure does not invariably lower financing costs. Richardson and Welker (2001) found a positive association between social disclosure and cost of equity in their sample, although better financial performance moderated the relationship. Such findings illustrate that additional disclosure is not necessarily interpreted favourably when investors question its economic content or credibility.

The Indian evidence has also produced this counterargument. Dahiya and Singh (2021), studying Indian manufacturing companies, found that CSR was positively associated with cost of equity, indicating that investors did not necessarily view CSR as value-enhancing during the study period. Prasad et al. (2022) similarly reported that higher CSR performance could increase the cost of equity in their Indian sample and showed that mandatory CSR policy influenced the CSR-financing relationship.

These findings suggest that ESG's financial benefits are not automatic. Sustainability expenditure must be credible, economically relevant and effectively communicated to investors.

6. Greenwashing and ESG Credibility

A further complication occurs when the ESG information disclosed by companies does not accurately represent their actual environmental or social performance. Greenwashing can create an attractive sustainability image without equivalent underlying improvements. Such behaviour can eventually increase reputational and regulatory risk rather than reduce it.

Credibility is therefore as important as the volume of disclosure. If investors suspect that sustainability reporting is largely symbolic, ESG information may fail to reduce information asymmetry. Corporate misconduct can further undermine previously strong ESG reputations, increasing the premium demanded by investors. Becchetti et al. (2023) demonstrate that ESG misconduct carries an identifiable cost in equity markets, while the wider literature shows why disclosure quality needs to be distinguished from disclosure quantity.

For this reason, assurance and verification are becoming more important. India's BRSR Core framework represents an attempt to improve the reliability and comparability of a defined group of sustainability indicators rather than relying exclusively on broad voluntary narratives.

7. ESG Rating Disagreement

One of the most important recent developments in ESG research concerns **rating divergence**. Unlike conventional financial measures, a single universally accepted ESG score does not exist. Different agencies may assign considerably different scores to the same company.

Berg, Kölbel and Rigobon (2022) decomposed ESG rating disagreement and found that differences in measurement accounted for the largest component of divergence, followed by differences in scope and weighting. Their findings demonstrate that two agencies can reach different conclusions even when examining the same company because they define and measure sustainability differently.

Christensen et al. (2022) further show that greater disclosure may actually accompany greater rating disagreement rather than automatically producing convergence. This creates an important problem for investors because a firm's apparent ESG quality can depend partly on which rating provider is consulted.

More recent evidence links this issue directly with financing costs. Lou et al. (2025) find that ESG rating disagreement increases the cost of equity capital among Chinese listed firms, primarily by reducing investor confidence. Thus, even when better ESG performance potentially reduces financing costs, inconsistent measurement can weaken that advantage.

8. Evidence from India

Indian evidence has evolved considerably. Earlier studies were more sceptical regarding whether socially responsible activity was financially rewarded. Dahiya and Singh (2021), studying 68 NSE-listed manufacturing firms during 2013-2018, reported a positive relationship between CSR and cost of equity. This suggested that, at that stage of the Indian market's development, investors may have interpreted CSR spending partly as a cost rather than as an indicator of lower long-term corporate risk.

However, more recent evidence increasingly points in the opposite direction. Mathath, Kumar and Balasubramanian (2025) examined 586 Indian firms during 2015-2022 and found that superior ESG disclosure was associated with a lower cost of equity. Importantly, the governance component was primarily responsible for this reduction. Their study did not find a significant differential moderating effect from Big Four auditors on the ESG-cost-of-equity relationship.

Patro, Mishra and Lee (2025), using 2,454 Indian firm-year observations from 2016-2021, likewise found that higher ESG scores were related to lower equity financing costs. Their results additionally suggested that Big Four auditors strengthened this negative relationship by

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enhancing the credibility of ESG reporting. This is particularly interesting because it differs from Mathath et al. regarding the moderating role of audit quality, illustrating that even recent Indian evidence is not completely uniform.

Research on related financing dimensions supports the growing financial importance of ESG. Malik and Kashiramka (2024), analysing 272 NSE-listed Indian firms, examined ESG disclosure in relation to financial performance, valuation and cost of debt. Mathath, Kumar and Balasubramanian (2024) also found that ESG disclosure was negatively associated with the cost of debt, with the effect differing according to firms' life-cycle stages. Together, these studies indicate that sustainability information is becoming relevant across different components of corporate financing in India.

Most recently, Malik, Kashiramka and Sharma (2026) found that higher ESG disclosure among NSE 500 non-financial firms was associated with lower debt-to-equity ratios, suggesting improved access to equity financing. Their mediation analysis identified both cost of debt and cost of equity as channels through which ESG disclosure can affect corporate capital-structure decisions.

9. Summary of Major Literature

Study	**Context**	**Major Finding**
Richardson & Welker (2001)	Canada	Social disclosure was positively related to cost of equity in their sample.
Dhaliwal et al. (2011)	International/US firms	High-quality CSR reporting and performance could reduce cost of equity.
El Ghoul et al. (2011)	United States	Better CSR performance was associated with cheaper equity financing.
Ng & Rezaee (2015)	Large international sample	Sustainability performance was generally negatively related to cost of equity, with differences across ESG dimensions.
Dahiya & Singh (2021)	India	CSR was positively related to cost of equity for the manufacturing firms studied.
Christensen et al. (2022)	International ESG ratings	Greater ESG disclosure did not necessarily reduce rating disagreement.
Berg et al. (2022)	Six ESG rating agencies	ESG ratings diverged due mainly to measurement and scope differences.
Becchetti et al. (2023)	United States	ESG misconduct and reputational risk increased cost of equity.
Li et al. (2024)	China	ESG ratings reduced cost of equity through lower information asymmetry and operational risk.
Mathath et al. (2025)	India	ESG disclosure reduced cost of equity, mainly through governance disclosure.
Patro et al. (2025)	India	Higher ESG scores reduced cost of equity; Big Four audit strengthened the relationship.
Lou et al. (2025)	China	ESG rating disagreement increased cost of equity by weakening investor confidence.

The literature therefore does not support the overly simple proposition that **"more ESG always means lower cost of equity."** Instead, the effect depends on the quality and credibility of ESG information, institutional context, individual ESG dimensions, measurement methodology and investor interpretation.

10. Discussion

The literature reveals an important evolution in the ESG-cost-of-equity debate. Early research largely employed CSR measures, while more recent studies increasingly use detailed ESG scores, pillar-level indicators and third-party ratings. The evidence has correspondingly shifted from asking whether corporate responsibility has financial value to examining **how, when and through which mechanisms ESG affects investor-required returns**.

Three mechanisms emerge most consistently. First, better ESG information can reduce information asymmetry. Second, credible ESG performance can reduce perceived operational, regulatory and reputational risk. Third, governance and credible external monitoring can increase investor confidence. These mechanisms provide a logical explanation for the negative ESG-cost-of-equity relationship documented in much of the recent literature.

At the same time, the inconsistent findings should not be dismissed as statistical noise. They reveal genuine differences across countries, industries, time periods and ESG measurement systems. Manufacturing firms, for example, may face different environmental risks and sustainability costs from service-sector firms. Similarly, investors in a developing ESG market may initially interpret sustainability expenditure differently from investors in markets where ESG information has already become integrated into mainstream valuation practices.

India illustrates this transition particularly well. Earlier evidence suggested that socially responsible expenditure could raise equity financing costs, whereas newer post-regulatory evidence increasingly identifies a financing advantage from strong ESG disclosure. This change may partly reflect improvements in sustainability reporting, greater investor familiarity with ESG concepts, stronger regulatory frameworks and a growing ability to distinguish sustainability performance from generic CSR expenditure. This interpretation is an inference from the changing empirical evidence and regulatory evolution rather than a settled causal conclusion.

11. Research Gaps and Future Scope

Despite the rapidly expanding literature, several issues remain unresolved. First, future Indian studies should distinguish **ESG performance from ESG disclosure**. A company can disclose extensively without necessarily performing better environmentally or socially, and treating the two concepts as interchangeable may generate misleading findings.

Second, individual ESG pillars deserve greater attention. Evidence from Mathath et al. (2025) indicates that governance disclosure plays an especially important role in reducing the cost of equity in India, while international evidence suggests that environmental and governance effects may differ considerably from social effects.

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Third, ESG rating disagreement requires more investigation in the Indian market. Since SEBI now regulates ESG Rating Providers, India provides an interesting setting for examining whether regulatory standardization improves rating convergence and whether greater agreement among rating agencies reduces firms' financing costs.

Fourth, future research should investigate non-linear relationships. Extremely low ESG engagement may increase risk, but very high expenditure could potentially create diminishing financial benefits. Sectoral comparisons between environmentally sensitive and relatively low-impact industries would also improve understanding.

Finally, the effects of BRSR and BRSR Core provide an important opportunity for future longitudinal research. Comparing firms before and after mandatory standardized sustainability disclosure could help determine whether improved information quality itself reduces equity financing costs rather than merely being associated with them.

12. Managerial and Policy Implications

For corporate managers, the literature suggests that ESG should not be regarded exclusively as a compliance expense. Credible sustainability practices can potentially influence the company's risk profile, information environment and ultimately the rate of return required by investors. However, the emphasis must remain on measurable performance rather than decorative reporting. Greenwashing or inconsistent sustainability information may destroy rather than create financing advantages.

For investors, ESG ratings should be interpreted cautiously. Divergence among rating providers means that a single composite ESG score may conceal important differences in environmental, social and governance performance. Investors may therefore benefit from examining pillar-level indicators and the methodology underlying ratings.

For Indian regulators, the existing BRSR and ESG rating frameworks represent important steps toward standardization. Continued attention to comparability, credibility, assurance and proportional reporting requirements can improve the usefulness of ESG information for capital-market participants.

13. Limitations

This paper is a narrative review and therefore does not apply a formal systematic-review or meta-analytical procedure. The reviewed studies use different ESG databases, cost-of-equity measures, countries, sample periods and econometric techniques, making direct comparison difficult. Moreover, ESG regulation and measurement continue to evolve rapidly. The findings should therefore be interpreted as a synthesis of the major theoretical arguments and empirical tendencies rather than as evidence of one universally applicable ESG-cost-of-equity relationship.

14. Conclusion

The relationship between ESG and the cost of equity has become an important area connecting sustainable management with corporate finance. The literature generally suggests that credible

ESG performance and disclosure can reduce equity financing costs by lowering information asymmetry, improving corporate reputation, reducing perceived risk and strengthening investor confidence. However, the relationship is not unconditional. Excessive or poorly justified ESG expenditure, greenwashing, inconsistent disclosure and disagreement among rating agencies can weaken or reverse these benefits. The Indian evidence is particularly noteworthy because earlier studies reported positive relationships between CSR and cost of equity, whereas more recent studies increasingly find that stronger ESG disclosure is associated with lower equity financing costs. The evolution of BRSR, BRSR Core and ESG-rating regulation may further strengthen the role of sustainability information in Indian capital markets. Overall, the literature indicates that the financial value of ESG depends less on merely reporting a high sustainability score and more on whether sustainability performance is credible, comparable, relevant and trusted by investors.

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