



Will it Transform from  
Compliance Tool to  
Capital Signal?

SEBI has recently constituted a working group to review the regulatory framework governing ESG Rating Providers (ERPs). This follows stakeholder feedback on the 2021 framework and reflects a broader global push towards improving transparency, reliability, comparability and governance of ESG ratings.

This is a timely move. India built an ESG ratings ecosystem early and decisively. But the market now needs the next phase: from structure to substance.

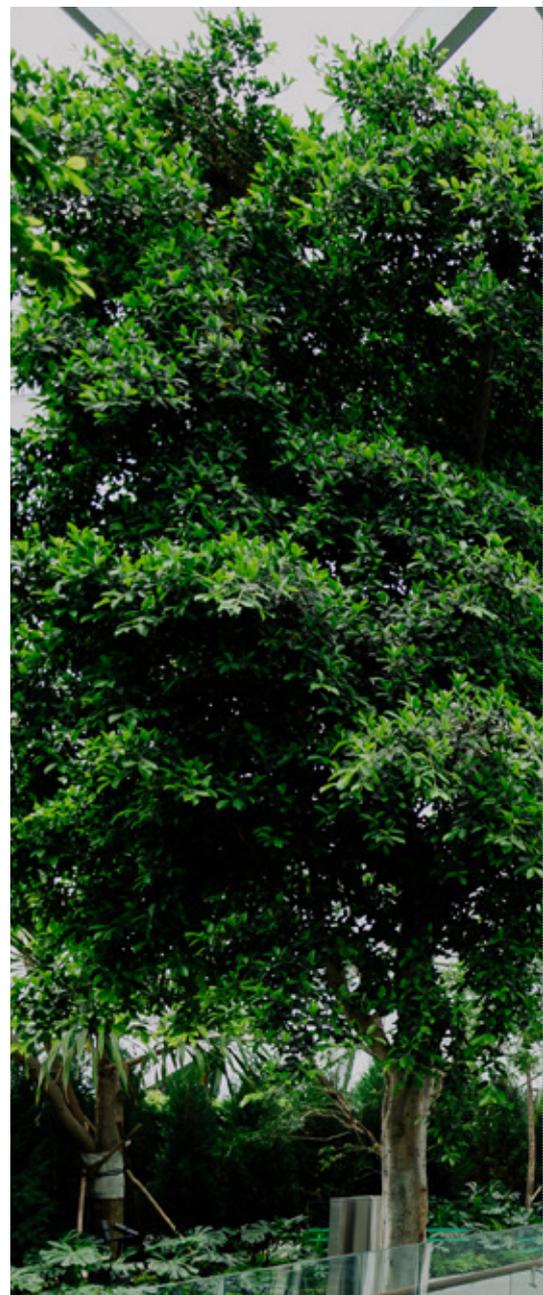
## The Regulatory Architecture: What Exists Today

### 1. ISSUER-PAID VS SUBSCRIBER/INVESTOR-PAID MODELS

Unlike credit rating agencies (which operate primarily on an issuer-paid model), SEBI allowed two models for ESG ratings:

- 🌿 **Issuer-paid model:** The rated company pays the ERP. This allows structured engagement with management, data clarification, and detailed rating rationales. The risk here is perceived conflict of interest, which must be managed through governance safeguards, similar to credit rating agencies.
- 🌿 **Subscriber (Investor)-paid model:** Revenue comes from subscribers such as mutual funds, banks, insurance companies, institutional investors or even corporates. Under this model, ratings are generally based only on publicly available information, with limited engagement with the company. The advantage is independence but the limitation is depth.

This dual structure was envisaged to be a progressive move. But it has also created fragmentation in expectations and outputs.

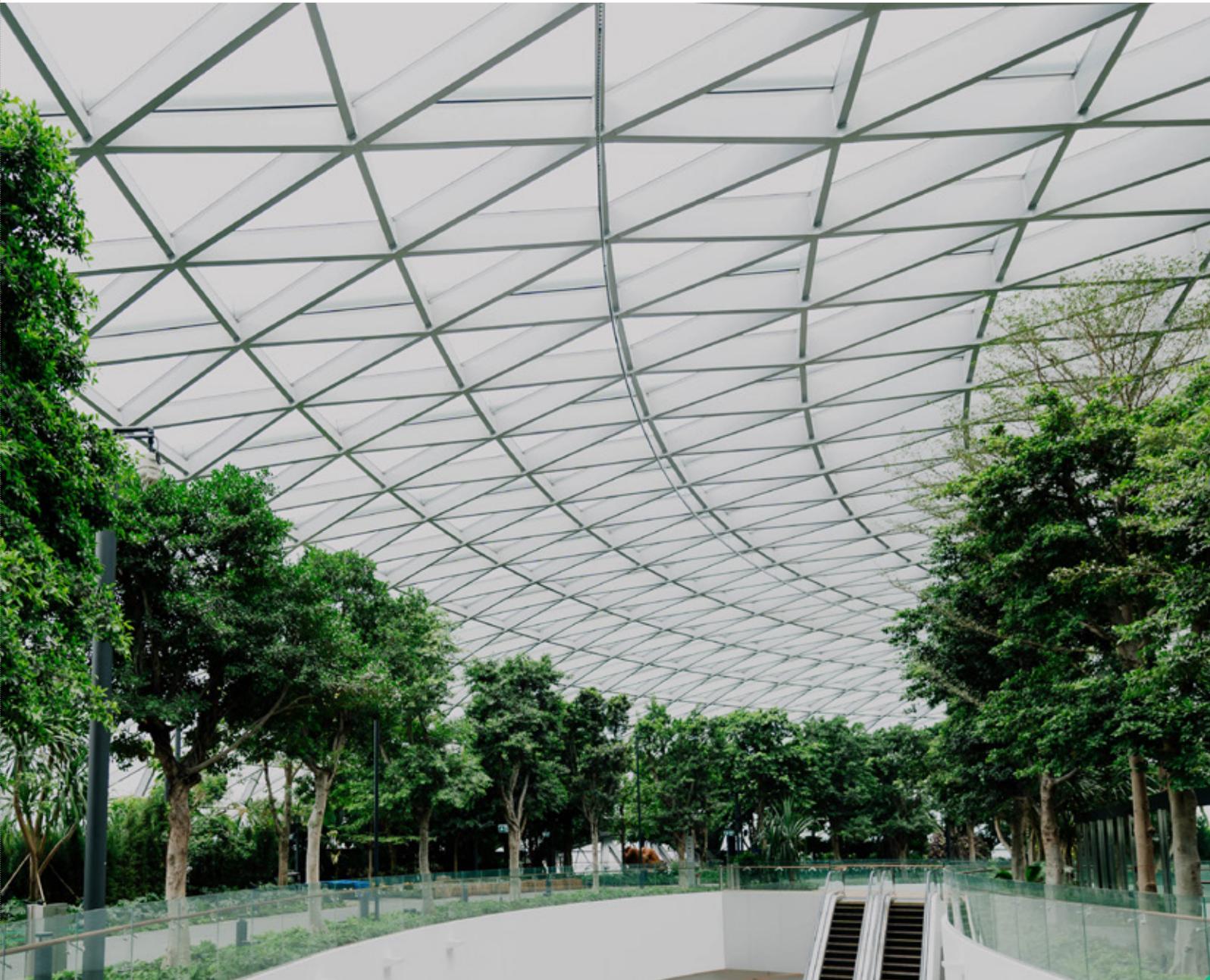


### 2. CATEGORY I AND CATEGORY II ERPS

SEBI introduced two categories of ESG Rating Providers to widen participation and build market capacity.

- 🌿 **Category I ERPs** are expected to meet higher eligibility thresholds and may undertake additional activities such as certification-related services (example: green bonds).
- 🌿 **Category II ERPs** operate within a narrower scope and lower entry requirements.

While this approach expanded the ecosystem, it also led to varying depth of sector expertise and analytical capability across players.



### 3. REGULATORY PERIMETER: ONLY SEBI-REGISTERED ERPS

For regulated use-cases in India—particularly within SEBI’s jurisdiction—ESG ratings must be issued only by SEBI-registered ERPs. This ensures oversight, disclosure standards, and accountability.

While this strengthens domestic regulatory control, it has also had market consequences. Many global rating players such as Sustainalytics, S&P, and MSCI have reduced or exited locally regulated ESG ratings business rather than operate under the Indian ERP framework. The result is a domestically driven rating ecosystem alone.

# The Stakeholder Context: Why Adoption Is Still Muted



ESG ratings were envisioned as tools for:

- Investors
- Banks and lenders
- Customers and supply chains
- Other capital market stakeholders

**However, real adoption remains limited.**

Currently, the strongest regulatory pull comes from ESG-labelled mutual funds (just over 10 funds), which are required to disclose ESG scores from SEBI-registered ERPs as part of portfolio disclosures. Outside this regulatory requirement, market-driven demand is still developing.

Banks, while potential subscribers, are not under a strong mandate to incorporate ERP scores into lending decisions. Consequently, ESG ratings have not yet translated meaningfully into cost-of-capital differentiation.

Globally, supply chain sustainability assessments are often driven by frameworks such as EcoVadis, CDP, or customer-specific platforms rather than regulated capital-market ESG ratings. This creates parallel ecosystems with limited interoperability.



## Corporate Reality: The ROI Question

Among companies reporting under BRSR or sustainability frameworks, one recurring question emerges:

**“What is the return on overachieving sustainability performance?”**

Unlike credit ratings, where a notch upgrade can reduce borrowing cost, ESG ratings in India do not yet consistently translate into:

- Lower interest rates
- Tighter spreads
- Higher equity valuations
- Preferential financing terms

Further, sustainability risks often materialize over long time horizons. Estimating probability of default adjustments or equity risk premia attributable purely to ESG performance remains analytically complex and unclear.

Until capital pricing mechanisms visibly integrate ESG risk, ratings risk becoming compliance artifacts rather than financial signals.

## SME Context: Rising Costs, Limited Incentives

Small and medium enterprises are increasingly adopting ESG practices due to customer and supply chain requirements. However:

Compliance costs are high relative to size

Capability is limited

Incentives from lenders or buyers remain weak

Without a proportionate framework and tangible benefits, ESG adoption risks becoming burdensome rather than transformative for SMEs.

## Data and Comparability: The Core Structural Challenge

**Nearly all ERPs face the same issue: data reliability and comparability.**

Unlike financial reporting—where IFRS or Ind AS create standardized definitions, the sustainability reporting definitions remain less harmonized. The lack of well accepted universal body of established practice for measuring and evaluating non-financial information allows for different, but acceptable, measures and measurement techniques, potentially affecting comparability between entities.

For example, GHG emissions estimation involves inherent uncertainties due to varying methodologies, emission factors, boundary definitions, and assumptions. These differences can materially



impact reported figures, reducing comparability across entities, even when aligned to the same reporting framework.

Even when ERPs build sophisticated models with hundreds of data points across multiple pillars and themes, comparability breaks down if the underlying definitions vary.

Industry efforts such as the Indian Sustainability Framework (ISF) have improved harmonization, but sustainability measurement still allows multiple equally valid methodologies.



# Recommendations: Making ESG Ratings Fit for Purpose

To make ESG ratings relevant, reliable and economically meaningful, the following steps are critical:

## 1. RATIONALIZE AND PROFESSIONALIZE THE ERP ECOSYSTEM



Encourage consolidation or higher entry thresholds so that ERPs possess deep sectoral expertise, analytical capability and methodological robustness.

## 2. PRIORITIZE THE ISSUER-PAID MODEL (WITH STRONG GOVERNANCE)



While this may deviate from prevailing global practice, at the current stage of ecosystem maturity, structured engagement improves data quality and transparency. Conflict management mechanisms (already proven in credit ratings) can be replicated.

## 3. LINK RATINGS TO FINANCIAL INCENTIVES



Develop green and sustainability-linked lending frameworks where higher-scoring companies receive differential pricing. Without capital incentives, ratings will struggle to drive behavior.

## 4. CREATE A SIMPLIFIED SME ESG FRAMEWORK



Introduce a proportionate reporting and rating structure tailored for SMEs, with clear incentives for better performers.

## 5. STANDARDIZE BRSR KPI DEFINITIONS AND BOUNDARIES



Establish uniform KPI definitions, measurement methodologies, and reporting boundaries under BRSR. This will reduce interpretational variability and improve comparability across ESG ratings.

## 6. INTRODUCE EVIDENCE GRADING



Differentiate between assured, reported and estimated data within rating calculations to enhance transparency and credibility.

## The Bigger Opportunity

**India was early in regulating ESG ratings. The next step is evolution but not retreat.**

If ESG ratings move from being a disclosure companion to becoming a capital allocation signal, adoption will accelerate organically.

The SEBI review should not be a regulatory housekeeping. It is an opportunity to align sustainability performance with financial outcomes.

And when value begins to reflect values, markets transform.