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Will Higher ESG Rating Rankings Reduce Corporate Non-compliance

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Abstract: This paper explores the potential impact of ESG ratings on corporate non-compliance and its mechanism of action. Based on the data of China's A-share listed companies from 2007 to 2022, the ESG disclosure index is constructed as a control variable using textual analysis, and empirical analyses are carried out using a two-way fixed effects model. It is found that ESG rating ranking has a significant inhibitory effect on corporate non-compliance, and the effect is relatively weak among state-owned enterprises, enterprises with large ESG rating divergence, and enterprises with high external attention. Further mechanism tests show that ESG rating ranking indirectly inhibits corporate non-compliance by reducing corporate financing constraints. This finding reveals the important role of ESG ratings in promoting compliant operations and provides new perspectives for understanding the relationship between ESG ratings and firm behavior. The findings of this paper have important theoretical and practical implications for improving corporate governance mechanisms, promoting sustainable development, and optimizing capital market resource allocation.

Keywords: ESG ratings, corporate non-compliance, financing constraints, textual analysis

1. Introduction

With the deepening of the concept of sustainable development, ESG ratings, as a core tool for measuring corporate non-financial performance, have received increasing attention for their governance effects on corporate behavior. Existing studies mainly focus on the impact of ESG ratings on corporate value, green innovation and financing costs, and some of the literature preliminarily explores the negative association between ESG performance and non-compliance behavior. However, the intrinsic mechanism by which ESG ratings inhibit corporate non-compliance is not yet clear: on the one hand, ESG rating divergence and differences in external attention may weaken its governance effect; on the other hand, empirical evidence on financing constraints as a key transmission path is still insufficient. In addition, it remains to be tested whether the unique governance structure of SOEs affects the violation-suppressing effect of ESG.

Based on the data of Chinese A-share listed companies from 2007 to 2022, this paper innovatively empirically examines the inhibitory effect of ESG rating rankings on corporate non-compliance and its boundary conditions from the dual perspectives of signaling and governance synergy. A two-way fixed-effects model is applied to verify the direct impact of ESG rating ranking

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on corporate violations; financing constraints are included in the mediating path to reveal the transmission mechanism of ESG indirectly suppressing violations by alleviating financing pressure; and the moderating effects of state-owned enterprises, ESG rating divergence and external attention on the suppression effect are analyzed.

The contributions of this paper are: at the theoretical level: revealing the mediating path of ESG ratings to promote the alleviation of financing constraints and reduce violations, deepening the knowledge of the mechanism of ESG governance effects; clarifying the "double-edged sword" effect of rating disagreement and external attention on the inhibitory effect of ESG, and providing new evidence for the study of the "greenwashing" behavior. Provide new evidence for the study of "greenwashing" behavior. At the methodological level, we integrate ESG data from six mainstream institutions to construct market consensus rankings and reduce single rating bias; we use text analysis to construct ESG disclosure indexes and control the interference of corporate self-disclosure. Practical level: Provide the basis for regulators to improve ESG rating specifications; guide enterprises to obtain financing facilitation through optimizing ESG performance and achieve synergy between compliance and sustainable development.

2. Theoretical analysis and research hypotheses

ESG ratings discourage non-compliance by sending important market signals about a company's sustainability capabilities. A high rating not only reflects a company's good environmental, social and governance (ESG) performance, but also signals to stakeholders its high ethical standards and standardized operations, which enhances a company's reputation and credibility, and thus reduces the incentive for non-compliance. Good ESG performance attracts long-term investors and customers, bringing resources and opportunities; at the same time, in order to avoid rating downgrade and reputation loss due to non-compliance, companies will pay more attention to compliant operations. Therefore, as a market-based incentive mechanism, ESG ratings can motivate companies to actively improve their compliance level. In addition, ESG ratings also inhibit non-compliance through the synergistic effect of external monitoring and internal governance: the assessment process of rating agencies based on public information and strict standards enhances external monitoring pressure, which prompts enterprises to behave more prudently; in order to improve ratings, enterprises will strengthen internal governance mechanisms ,like improving internal control [1], which can effectively constrain the behavior of the management, and reduce non-compliance due to governance failures resulting in violations [2]. Therefore, this paper proposes the following hypotheses:

H1: ESG rating ranking has an inhibitory effect on corporate non-compliance.

Financing constraints are the key intermediary variable that inhibits non-compliance with ESG ratings, and as a symbol of sustainability, ESG ratings increase the attractiveness of the capital market, reduce the cost of financing, and alleviate financing constraints. When eased, firms have more flexibility in capital utilization and resource allocation, and can more effectively invest resources in strengthening compliance management and internal control construction, thus reducing non-compliance. At the same time, the alleviated financial pressure enables enterprises to respond to market challenges and short-term goals more comfortably and avoid resorting to non-compliant means of short-term profit-seeking due to financial constraints, thus reducing the motivation and possibility of non-compliance from the root. Therefore, this paper proposes the following hypotheses:

H2: ESG rating ranking inhibits corporate non-compliance by reducing corporate financing constraints.

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3. Research design

3.1. Sample selection and data source

This paper takes the data of China's A-share listed companies from 2007 to 2022 as the research sample and screens them as follows: (1) the indicators of CSMAR database are merged with the ESG rating data of each year, and the missing samples of the key variables are eliminated; (2) the financial companies are more different from the others in terms of operation mode and regulation, and the samples of the listed companies in the financial industry are eliminated; (3) the samples of the companies with ST and*ST samples of companies may have operational problems and high possibility of violation, and are excluded; (4) outliers with negative operating income and negative financial leverage are excluded. Finally, 36,906 observations are obtained. In order to avoid the influence of extreme values, the samples are subjected to the upper and lower 1% shrinkage. The research data of this paper comes from CSMAR database, WIND database and CNRDS database.

3.2. Variable setting

3.2.1. Core explanatory variables

The explanatory variable of this paper is corporate violations. Existing studies measure corporate violations in a variety of ways: designing a dummy variable based on whether the violation is or is not [3]; measuring the number of violations by year of the enterprise [4]; and considering penalties such as fines to measure the violation in terms of the severity of the violation [5]. In this paper, the number of annual violations is used to measure the number of violations, and the amount of fines is added to reflect the degree of violation in the robustness test. The data is from CSMAR database.

3.2.2. Core explanatory variables

Currently, the relevant departments have not formulated formal ESG rating standards, and the existing ESG rating data are mainly released by third-party rating agencies. The results of different ESG rating agencies are generally divergent due to differences in the scope of ratings, weight settings, measurement methods, and inclusiveness to the actual situation of enterprises. Wardell, CSI, FTSE Russell, Business Gateway Green, Allied Wave and MSCI, six domestic and international mainstream ESG rating agencies, with international influence and transparent methodology, convert the ratings of each agency into a percentage system and calculate the average value of the low to high ranking, respectively, assigning a value of 0 to 1, with the higher value representing the higher ranking of the ESG ratings of the enterprises, and then calculate the average, which reflect the ESG ratings ranking, and better represent the market consensus. It is more representative of the market consensus.

3.2.3. Control variables

First is the ESG Disclosure Index (ESG_mind) In order to adopt the text analysis method more, the dictionary related to ESG is designed. The control variables are constructed by systematically analyzing the text of annual reports of listed companies and calculating the frequency of occurrence of words related to environmental, social and governance dimensions in them. The lexicon for the environmental dimension covers terms related to corporate resource efficiency, pollutant emissions, ecological protection measures, and sustainable development practices; the lexicon for the social

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dimension includes terms related to the fulfilment of corporate social responsibility, protection of employees' rights and interests, maintenance of community relations, and communication with stakeholders; the lexicon for the governance dimension focuses on key elements such as the corporate governance structure, the internal control mechanism, the quality of disclosure, and the protection of shareholders' rights and interests. The expression of key elements such as the protection of shareholders' rights and interests. Calculating the word frequencies of the terms related to these dimensions can reflect more objectively the degree of attention paid by enterprises to ESG practices, eliminate the potential impact of enterprises' own differences in ESG practices on their non-compliance behavior, and reveal more accurately the independent inhibitory effect of ESG ratings ranking on their non-compliance behavior, so as to make the results more robust.

The word frequency analysis of ESG-related terms in 2007 corporate annual reports reveals the characteristics and trends of corporate disclosure in the environmental, social and corporate governance dimensions at that time. In the environmental dimension, enterprises have shown some awareness of environmental protection, but their disclosure of environmental information is more of a conceptual description and lacks attention to and disclosure of key environmental indicators. In the social dimension, the frequency of mentioning the terms of "social responsibility", "employee welfare" and "health and safety" is 6895, 183 and 127 times respectively, which shows that the enterprises have already made some progress in social responsibility awareness. In the dimension of corporate governance, the frequency of mentioning terms such as "information disclosure", "compliance" and "anti-corruption" is higher, showing that enterprises have already reflected their awareness of social responsibility.in the dimension of corporate governance.

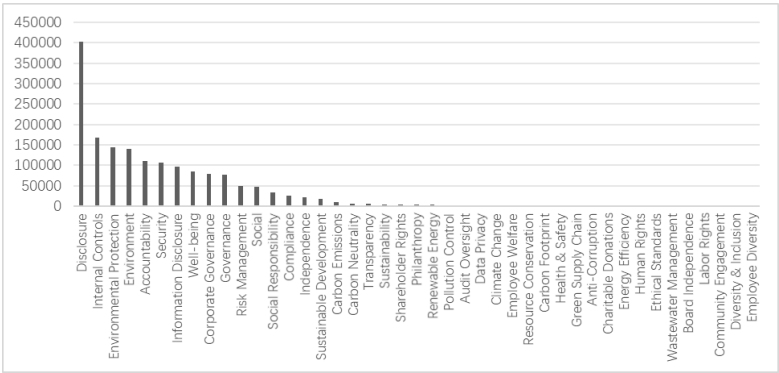

Figure 1. Word frequency of ESG related words in 2022 annual report

In the word frequency analysis of ESG-related terms in the 2022 annual reports of enterprises, enterprises' disclosure in the environmental, social and corporate governance dimensions presents significant differences and characteristics. Enterprises are more inclined to general descriptions in the environmental dimension, there is a difference between the broad perception of social responsibility and the disclosure of specific areas of practice in the social dimension, and more emphasis on information transparency and relatively insufficient disclosure of key governance mechanisms in the corporate governance dimension. Figure 2 shows the results of the textual analysis of 2022 reports.

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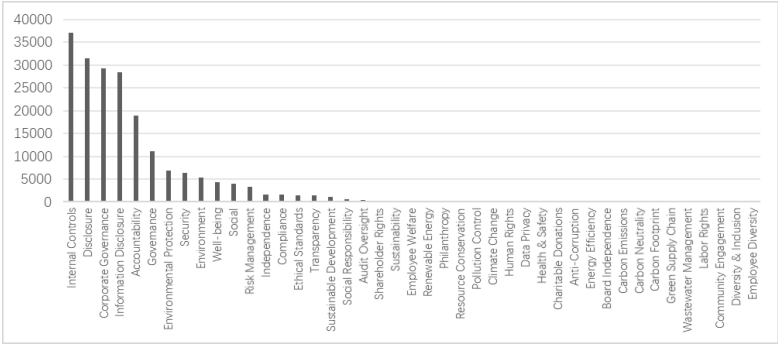

Figure 2. Word frequency of ESG related words in 2007 annual report

Compared with 2007, the frequency of ESG-related terms in the 2022 annual reports of enterprises shows a significant increase and change. In the environmental dimension, the frequency of key environmental indicators such as "carbon emission", "footprint" and "renewable energy" has increased significantly, reflecting the shift from conceptual description to specific indicator disclosure in environmental information disclosure. This reflects a shift from conceptual descriptions to disclosure of specific indicators, and a significant increase in the depth and breadth of environmental strategies. In the social dimension, the frequency of "community involvement" and "charitable donations" has also increased significantly, indicating that enterprises have become more diversified in their social responsibility practices and increased their participation in social welfare. In the dimension of corporate governance, although the frequency of mentioning key governance mechanisms like "risk management" is lower than that of terms like "information disclosure", the overall trend is increasing. In terms of corporate governance, the frequency of mentioning key governance mechanisms like "risk management" and "anti-corruption" is still lower than that of terms such as "information disclosure", but the overall trend is upward, showing that enterprises have made progress in disclosing the depth of their governance structures and mechanisms. From 2007 to 2022, enterprises' ESG disclosure shows a shift from conceptual descriptions to disclosure of specific indicators, from internal governance to diversified social responsibility practices, and from the appearance of governance structure to in-depth disclosure of key mechanisms, reflecting the deepening and perfecting of enterprises' knowledge and practice of ESG concepts.

Firm characteristics that may be associated with corporate non-compliance are controlled: firm size (size); profitability (roa); financial leverage (lev); age at listing (age); firm value (tbq); number of employees (sta); accounting robustness (Sumbeta); total number of supervisors (TN); number of board members (DN); and percentage of independent directors (DD).

3.3. Model setting

A firm and year two-way fixed effects model is constructed to empirically analyze the relationship between ESG rating ranking and corporate violations:

$$vio\_num_{it} = \alpha + \beta ESG\_Rank_{it} + \sum Controls_{it} + \sum Firm_i + \sum Year_t + \varepsilon_{it} \quad (1)$$

Where i and t are year and firm; ε is a random disturbance term. The explanatory variable vio_num is the number of corporate violations in period t; ESG_Rank is the ESG rating ranking of firms in period t; $\sum Controls_{it}$ is the relevant control variable; $\sum Firm_i$ is the firm fixed effect;

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and $\sum Year_t$ is the year fixed effect. β is the coefficient of focus, which indicates the effect of ESG rating on corporate violations.

4. Analysis of empirical results

4.1. Descriptive statistics and correlation coefficient test

Table 1 shows the descriptive statistics of the main variables. The mean value of the explanatory variable, the number of corporate violations (vio_num), is 0.246, indicating that the average number of corporate violations in the sample is about 0.25 per year, which is relatively small in general, suggesting that listed companies in China have fewer violations over the years, and the majority of them do not have any violations, while a few of them have high-frequency violations. The distribution of the core explanatory variables ESG rankings indicates that the ESG ratings of the head firms span a wide range and the distribution of the tail firms is more concentrated.

Table 1. Descriptive statistics

Variable	N	Mean	SD	Min	p25	p50	p75	Max
vio num	36906	0.208	0.568	0	0	0	0	3
ESG_Rank	36906	0.444	0.253	0.0100	0.240	0.380	0.670	1
ESG mind	36906	2.616	1.123	0	2.652	2.986	3.228	4.136
size	36906	22.13	1.308	19.79	21.18	21.93	22.86	26.21
tbq	36906	2.018	1.266	0.855	1.249	1.609	2.291	8.357
lev	36906	0.408	0.202	0.0500	0.245	0.399	0.558	0.867
roa	36906	0.0540	0.0410	0.00200	0.0230	0.0450	0.0740	0.211
sta	36906	7.628	1.312	0.693	6.758	7.552	8.421	13.25
age	36906	2.870	0.372	0	2.639	2.890	3.135	4.234
SumBeta	36906	0.191	0.710	-1.355	0.0280	0.0780	0.189	3.313
TN	36906	2.830	0.204	1.386	2.708	2.833	2.944	4.007
DN	36906	8.601	1.725	0	7	9	9	18

Person and Spearman correlation coefficients show that the absolute value of the correlation coefficient between the main variables is lower than 0.6, and the maximum value of the variance inflation factor of the explanatory variables for the VIF test of multicollinearity is 2.03, and the mean value is 1.43 are both significantly less than 10, indicating that there is no serious problem of multicollinearity between the variables. The ESG rating ranking and the violation of the firms are significantly negative at the 1 per cent level, indicating that, without taking other factors into account, the ESG rating ranking increase significantly reduces corporate violations, confirming hypothesis H1.

4.2. Benchmark regression

Table 2 reports the results of the benchmark regression. The core explanatory variables ESG rating ranking are both significantly negative at the 1% level in models (1) and (2), indicating that higher ESG rating ranking has a stronger inhibitory effect on corporate non-compliance, and the effect remains robust after controlling for variables such as firm size, financial leverage (lev), and

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profitability (roa).Specifically, a one-unit increase in ESG rating ranking will reduce the number of corporate violations by 35.52%, supporting the research hypothesis.

Table 2. Benchmark regression

	(1)	(2)
	vio_num	vio_num
ESG_Rank	-0.3725***	-0.3570***
	(-21.9512)	(-20.8680)
ESG_mind		0.0813***
		(6.1106)
size		-0.0310***
		(-3.3405)
tbq		0.0114***
		(3.0871)
lev		0.2570***
		(7.9946)
roa		0.1159
		(1.0909)
sta		-0.0072
		(-0.9718)
age		0.0627
		(1.6294)
SumBeta		0.0013
		(0.2292)
TN		-0.0209
		(-0.5898)
DN		0.0052
		(1.2320)
DD		0.3363***
		(3.7177)
_cons	0.3734***	0.4692**
	(46.4662)	(2.1534)
N	36906	36906
adj. R2	0.1037	0.1075

4.3. Robustness tests

(1) propensity score matching analysis, in order to overcome the "selection bias" caused by biased estimation and sample selection, and to more accurately measure the effect of the intervention of ESG rating ranking, grouping with 0.5 as the boundary, selecting all the control variables as covariates, and performing nearest-neighbor matching with 1:3 matching between the two groups; (2) replacement of the explained variables, the enterprise's annual violation of the penalty into the

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measure of corporate violations, the penalty with a certain weight and the number of violations, in order to overcome the defects of the simple counting method ignoring the severity of violations, the construction of a weighted violation index, the more fines means that the more serious corporate violations, the results are shown in Table 3, Column (2); (3) replacement of the explanatory variables, the use of ln (vio_num +1) to compress the effect of extreme values, and the results are shown in column (3) of Table 3; (4) because operational risk increases the pressure of management fraud, which may lead to an increase in firms' violations, a control variable for operational risk is added, and the results are shown in column (4) of Table 3; and (5) double clustering of firms and years is performed to examine whether the results are robust and significant, and the results are shown in column (5) of Table 3.Table 3 shows that the hypothesis that controlling for sample selection bias, replacement variables, and ESG rating rankings have a dampening effect on firms' non-compliance significantly holds and the findings are robust.

Table 3. Results of robustness tests

	(1)	(2)	(3)	(4)	(5)
	vio_num	vio_num_adj	vio	vio_num	vio_num
ESG_Rank	-1.1097***	-0.4822***	-0.1943***	-0.3569***	-0.3570***
	(-12.2577)	(-20.9146)	(-20.3995)	(-20.8560)	(-8.2788)
ESG_mind	0.1417***	0.1119***	0.0457***	0.0812***	0.0813***
	(4.2464)	(6.2422)	(6.1742)	(6.1071)	(4.0922)
Controls	YES	YES	YES	YES	Controls
_cons	1.5246***	0.9191***	0.1840	0.4689**	0.4692
	(2.7006)	(3.1301)	(1.5171)	(2.1520)	(1.6182)
N	7359	36906	36906	36906	36906
adj. R2	0.1032	0.0901	0.1065	0.1075	0.1075

4.4. Mechanism tests

According to Hypothesis 2, corporate ESG rating ranking can influence corporate non-compliance through financing constraints. Drawing on the method of mediation effect test in Wen Zhonglin et al. [6], the model is constructed as follows:

$$\mathrm{Path}_{i,t} = \beta_0 + \beta_1 \mathrm{ESG\_Rank}_{i,t} + \sum \mathrm{Controls}_{i,t} + \sum \mathrm{Firm}_i + \sum \mathrm{Year}_t + \varepsilon_{i,t} \quad (2)$$

$$\mathrm{vio\_num}_{i,t} = \gamma_0 + \gamma_1 \mathrm{ESG\_Rank}_{i,t} + \gamma_3 \mathrm{Path}_{i,t} + \sum \mathrm{Controls}_{i,t} + \sum \mathrm{Firm}_i + \sum \mathrm{Year}_t + \varepsilon_{i,t} \quad (3)$$

In the above equation, Path corresponds to the financing constraint, which is measured by the SA index and the cost of credit. Results show that ESG rating ranking reduces SA index and credit cost, and corporate financing constraints are alleviated, suggesting that high ESG ratings attract low-cost funds through signaling, alleviate corporate financial constraints, and inhibit non-compliant behaviors triggered to alleviate the pressure on funds, and the results in Table 4 validate hypothesis H2.

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Table 4. Mechanistic tests of financing constraints

	(1)	(2)	(3)	(4)
	SA	vio_num	cost	vio_num
ESG_Rank	-0.0118***	-0.3525***	-0.0949***	-0.3560***
	(-5.6312)	(-20.6191)	(-4.1583)	(-20.8073)
ESG_mind	-0.0047***	0.0831***	-0.0036	0.0813***
	(-2.8929)	(6.2502)	(-0.2038)	(6.1138)
SA		0.3775***		
		(8.2998)		
cost				0.0102**
				(2.4424)
Controls	YES	YES	YES	YES
_cons	3.4358***	-0.8278***	1.2866***	0.4561**
	(128.7128)	(-3.0894)	(4.4283)	(2.0926)
N	36906	36906	36906	36906
adj. R2	0.9401	0.1094	0.4133	0.1077

5. Further research

State-owned enterprises (SOEs) are under the direct supervision and policy guidance of the government, and their business objectives are not only limited to economic interests, but also bear the dual mission of social responsibility and policy implementation. In this context, the decision-making process of SOEs tends to be more complex and subject to the constraints of multiple stakeholders, including government departments, the public, and management within the enterprise. This complex governance structure may lead to less flexibility in behavioral adjustments when firms face ESG rating pressures. In addition, SOEs may rely more on administrative means than on market mechanisms for resource allocation, which makes the inhibiting effect of ESG rating rankings on corporate non-compliant behaviors less significant in SOEs. In their pursuit of policy objectives and social responsibility fulfilment, SOEs may ignore the market signals conveyed by ESG ratings to a certain extent, thus weakening the restraining effect of ESG rating rankings on their non-compliant behaviors. Column (1) of Table 5 illustrates this result.

The magnitude of ESG rating disagreement also affects the dampening effect of ESG rating rankings on firms' non-compliant behavior. When firms face large ESG rating disagreement, firms may fall into information overload, making it difficult to accurately judge the true value and importance of ESG ratings in the decision-making process, and reducing the importance they attach to ESG rating rankings. ESG rating disagreement may also trigger a fluke mentality in firms, which tends to wait for further clear signals from the market in the face of inconsistent ratings results, rather than actively adjusting their behavior to reduce the risk of non-compliance. In this case, the inhibiting effect of ESG rating rankings on corporate non-compliance is hardly effective. Column (2) of Table 5 illustrates this result.

The level of external attention significantly affects the inhibitory effect of ESG rating ranking on corporate non-compliance. Increased attention from analysts and annual reports implies that firms are subject to stricter market scrutiny and public pressure. However, on the one hand, firms may

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devote more energy to responding to short-term market reactions rather than fundamentally improving their ESG performance; on the other hand, high attention may lead firms to be more sensitive to negative information, and thus take superficial measures to cope with ESG rating pressures, i.e., "greenwashing" behaviors, rather than materially reduce non-compliance [7]. High attention may also exacerbate the herd effect in the market, causing investors and analysts to over-interpret the ESG rating results of firms, thus weakening the independent disincentive effect of ESG rating rankings on corporate non-compliance. The reduction in corporate non-compliance does not stem primarily from the constraints of ESG rating rankings, but is indirectly influenced by external monitoring and market pressure, so the direct inhibitory effect of ESG rating rankings is not significant enough among firms with high external attention. Columns (3)(4) of Table 5 illustrate this result.

Table 5. Heterogeneity analysis results

	(1)	(2)	(3)	(4)
	vio_num	vio_num	vio_num	vio_num
ESG_Rank #state_owned	0.1025***			
	(3.0307)			
ESG_Rank#esg_uncertain		0.2087***		
		(6.4887)		
esg#rep_cov			0.0036***	
			(5.7178)	
esg#ana_cov				0.0100***
				(6.7519)
N	36906	36426	36906	36906
adj. R2	0.1067	0.1162	0.1078	0.1082

6. Conclusion and implications

Through an empirical study on the data of Chinese A-share listed companies from 2007 to 2022, this paper reveals the inhibitory effect of ESG rating ranking on corporate non-compliance and its internal mechanism. The findings show that the improvement of ESG rating ranking can significantly reduce the occurrence of corporate violations, and this effect remains robust after controlling for firm characteristics such as firm size, profitability, and financial leverage. Further mechanism tests find that ESG rating rankings indirectly inhibit the occurrence of corporate violations by alleviating corporate financing constraints. Heterogeneity analyses indicate that the inhibitory effect of ESG rating rankings on corporate violations is relatively weak among SOEs, firms with large ESG rating divergences, and firms with high external concerns. This phenomenon may be related to the complex governance structure of SOEs, information overload due to ESG rating divergence, and short-term corporate behavior triggered by external attention.

Based on the above findings, this paper makes the following recommendations. For enterprises, they should fully recognize the importance of ESG ratings for their long-term development, and use them as an important tool to enhance their reputation and sustainability. Enterprises should take the initiative to optimize their internal governance mechanisms and strengthen the transparency and accuracy of ESG information disclosure in order to enhance the market's trust in their ESG performance. Enterprises should proactively address ESG rating disagreements, communication

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with rating agencies and internal management improvements to reduce rating discrepancies due to information asymmetry. Enterprises should also pay attention to the potential impact of financing constraints on non-compliance, and rationally plan the use of capital and optimize capital structure to reduce the incentives for non-compliance triggered by financial constraints.

From the social level, investors and the public should pay more attention to the ESG performance of enterprises and take ESG ratings as an important reference basis for investment decisions. The guidance of the market mechanism will prompt enterprises to pay more attention to ESG performance and promote the sustainable development of the whole society. Society should strengthen the supervision and regulation of ESG rating agencies to avoid misleading corporate decision-making and social resource allocation due to rating differences.

For the government, it should further improve relevant policies and regulations, strengthen supervision of corporate ESG disclosure, and promote the establishment of sound internal governance mechanisms. Encourage enterprises to improve their ESG performance through policy guidance and incentives, such as tax incentives or policy support excellent ESG performance. The government should also strengthen regulation of the ESG rating market, promote cooperation and coordination among rating agencies, reduce rating disagreements, and improve the credibility and market influence of ESG ratings. The government should strengthen the assessment and supervision of the ESG performance of state-owned enterprises, and guide SOEs to better fulfil their social responsibilities while pursuing economic interests, playing a leading role in the sustainable development of society.

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