

January 4, 2021

Introduction to Financial Services: Environmental, Social, and Governance (ESG) Issues

ESG is a widely used acronym for environmental, social, and governance issues. Corporate governance—concerns about how companies should be managed—has evolved over time to include, arguably, a wider array of issues that encompass ESG. Some consider ESG factors to be an integral part of discussions about sustainability. According to one definition, *sustainability* at the firm level is “an approach that creates long-term shareholder value through managing opportunities and risks that derive from economic, environmental and social developments.”

Over 3,000 signatories with over \$103 trillion in assets under management support Principles for Responsible Investment (PRI), a nongovernmental organization (NGO) that promotes sustainability through ESG. Although the UN initiated PRI in 2005, the six principles of responsible investment were launched at the New York Stock Exchange in 2006 with 100 initial signatories. Over the years, as more signatories have joined PRI, they have increasingly asked investment managers to incorporate ESG factors in their investment decisions. In addition, state regulators, NGOs, and some Securities and Exchange Commission (SEC) commissioners and advisory groups have increasingly taken interest in ESG concerns. Congressional interest has centered on what types of ESG disclosures, if any, should be required.

What Is ESG?

There is no universally agreed-upon definition of what constitutes ESG. Investors and other stakeholders consider a wide-ranging array of topics as part of ESG. The discussion below on the characteristics and risks that can accompany ESG is not definitive. It is meant to illustrate some of the perceived risks of either addressing or ignoring various ESG factors.

Characteristics and Risks

Environmental. Investors and stakeholders may examine a firm’s impact on the environment. Some consider the interaction with the environment to be a form of capital—the stock of natural resources. Environmental risks include declining biodiversity; pollution; resource scarcity; and potential climate change impacts, including increasingly frequent and severe floods, hurricanes, and forest fires.

For individual firms, ignoring environmental risks could potentially harm their reputations, endanger employees, and imperil physical operations, which could lead to costly litigation. For other firms and communities, addressing environmental risks might cause economic harm, with diminished access to natural resources and the need to either physically relocate or seek alternative production inputs at a higher cost and diminished profits.

Social. Social factors encompass a firm’s effects on its various stakeholders, such as consumers, employees, suppliers, contractors, and the local and broader communities. Risks include potential infringement on the rights of others; gender- or ethnicity-based discrimination when hiring or promoting employees; failure to monitor supplier and contractor pay; handling of customer data in a nontransparent and nonsecure way; political spending; and investing in projects or sectors that could be considered objectionable to specific segments of society. Companies that handle these risks poorly might experience effects similar to environmental risks, such as the inability to attract quality employees and exposure to costly litigation.

In addition, some stakeholders might consider certain business operations or funding of certain entities in various areas to be unacceptable, including tobacco, gun manufacturing, private prison industries, abortion providers, and gambling. On the other hand, other stakeholders might consider an infringement of their rights any limitations placed on their right to operate or fund such lawful entities.

Governance. A firm’s self-governance and integrity when conducting business may raise questions. The policies, processes, and controls implemented by a firm help to define its self-governance and impact on various stakeholders. A firm’s integrity is measured by whether it avoids corruption and bribery and engages with individuals and other firms that may pose a reputational risk to the firm.

If a corporation chooses not to address governance issues, the associated risks could include harm to its consumers and an environment leading to criminal activity and corporate reputational harm, potentially resulting in firm failure. Firm failure negatively affects stakeholders—employees may lose their jobs, suppliers might not be paid, and local governments may receive less tax revenue. Some examples are Enron (2001 bankruptcy), WorldCom (2002 bankruptcy), and MF Global (2011 bankruptcy). Recently, the fake account scandal at Wells Fargo Bank harmed its clients, resulted in the removal of many key executives, and prompted regulators to restrict the bank’s growth.

Materiality and ESG

The disclosure of material information is an important accounting principle. There is ongoing debate about what is material in determining which ESG factors a firm should target and disclose to investors. Discussion around what constitutes materiality is similar to discussion about what constitutes ESG—companies have discretion over what to include in both. Some proponents of ESG disclosure have stated that focusing on financial materiality would be most helpful to investors.

Financial materiality issues, as defined by the Sustainability Accounting Standards Board, “are the issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors.”

Financial materiality and ESG outcomes vary by firm. Focusing on specific ESG factors at one firm or industry may lead to different outcomes than focusing on the same factors at another firm or industry. For example, improving fleet fuel efficiency at a company that transports goods could improve its financial results while benefitting air quality. Applying the same set of ESG factors to a data warehouse might not make sense; in that instance, lowering the cost of electricity (which could depend on the relative cost of fossil fuels versus renewable energy) probably would be more relevant for the warehouse’s financial outcomes.

Investors and other stakeholders might want to consider if a company is following the existing minimum federal and local statutory requirements. In addition, stakeholders might want to consider if a company’s ESG issues can be addressed through the existing regulatory regime—for example, all employers are subject to hiring and employment practices based on Equal Employment Opportunity Commission requirements and workplace safety based on Occupational Safety and Health Administration (OSHA) requirements.

Policy Issues

Much of the policy debate related to ESG involves questions over ESG disclosure requirements for companies. Proponents of requiring ESG disclosures in SEC filings argue that investors might positively perceive a company that includes additional ESG disclosures, which could result in increased revenues and profits for the company. Such disclosures also might help address long-term risks. Increased disclosure also could benefit firms if it results in increased access to lower cost of capital, especially when ESG disclosures are comparable across peer groups.

Critics argue that existing regulations already address many ESG issues, and the status quo—required disclosure when information is material; otherwise, voluntary disclosure at the firm’s discretion—is appropriate. Critics further argue that mandatory reporting of ESG factors based on an inflexible standard could be time-intensive and costly for companies and may be of minimal use if it is not material or comparable with reporting by peer companies. Such critics believe companies should focus on shareholder value, and some ESG proposals would distract from that goal. They believe government, not boardrooms, should set social policy.

Consistency in disclosure is another area of concern. In general, firms discuss ESG-related issues in the Management Discussion and Analysis (MD&A) section of their annual financial reports. Any ESG issues discussed in the MD&A section generally are not subject to an independent audit. Some studies have found that many companies report on ESG issues, but the information published by the companies is not standardized, and

investors can suffer from “information overload.” Inconsistent disclosure standards make it harder for investors to measure a firm’s performance on ESG issues; standardizing the disclosure requirements by industry could help investors and firms compare peer groups.

SEC and ESG

The aforementioned MD&A disclosures are part of Regulation S-K of the Securities Act of 1933 (P.L. 73-22) and subsequent updates. In August 2020, the SEC updated Regulation S-K to include risk factors. The update does not specifically require ESG disclosures, but it lets companies determine what material risks factors to disclose.

In December 2020, the SEC’s Asset Management Advisory Committee made the following recommendations about ESG disclosures:

The SEC should require the adoption of standards by which corporate issuers disclose material ESG risks.

The SEC should utilize standard setters’ frameworks to require disclosure of material ESG risks.

The SEC should require that material ESG risks be disclosed in a manner consistent with the presentation of other financial disclosures.

To date, the SEC has not adopted these recommendations. Other committees within the SEC have made similar recommendations. If Congress were to determine that the SEC should act on these recommendations, it could require the SEC to adopt them.

Congress and ESG

Congress has a number of options with respect to the SEC and ESG disclosures. Congress could consider requiring the SEC to mandate specific ESG-related issuer disclosure requirements. For example, Congress could require the SEC to amend federal securities laws to require issuers to disclose diversity information regarding their boards of directors, nominees for the boards, and executive officers. Alternatively, it could opt to defer to the SEC; some officials, but not all, have argued that mandating discrete ESG-related disclosures is unnecessary because they must be disclosed anyway if they are material.

CRS Resources

CRS In Focus IF11221, *Introduction to Financial Services: Corporate Governance*, by Raj Gnanarajah and Gary Shorter

CRS In Focus IF11222, *Corporate Governance: Board Diversity*, by Gary Shorter

CRS In Focus IF11307, *Climate-Related Risk Disclosure Under U.S. Securities Laws*, by Eva Su and Nicole Vanatko

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