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

Environmental, social, and governance (ESG) issues remain a highly debated concept among investors and public policy officials. As ESG is not a legally defined term and it encompasses a wide array of issues, arguably, what should be considered ESG is subject to interpretation. In recent Congresses, including the 119th, some Members have introduced proposals in support of and against ESG-related disclosure requirements, including materiality requirements. Furthermore, efforts are underway to roll back climate disclosures at the Securities and Exchange Commission (SEC), the President has recently signed an executive order to end diversity, equity, and inclusion (DEI) issues in federal contracting, and deregulation on a wide-range of environmental issues is being proposed and implemented.

Certain state and local governments have taken deregulatory actions on these issues, while other state and local governments have further enhanced ESG requirements.

Arguably, due to investor pressure and their own corporate governance principles, many corporations continue to report on aspects of ESG. To provide context to the ongoing debate about ESG issues, this In Focus provides an overview of characteristics and risks of addressing or not addressing ESG factors, including an introduction to *materiality*. The In Focus concludes by discussing recent SEC actions and identifying some of the bills introduced by Members in support of and against ESG requirements.

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 to be 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 publicly listed and private 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 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 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 poorly handle these risks 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 any limitations placed on their right to operate or fund such lawful entities an infringement of their rights.

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 could be 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). In the past decade, issues surrounding Wells Fargo Bank's creation of fake accounts not only harmed its clients but resulted in the removal of many key executives and prompted regulators to restrict the bank's growth. Similarly, as a result of deficiencies in the manufacturing quality of its planes, not only has the Boeing Company faced congressional, judicial and regulatory scrutiny, but it has suffered financial and reputational harm.

Materiality and ESG

The disclosure of material information is an important accounting and ESG principle. The notion of materiality is at the center of SEC-regulated disclosure requirements, especially as it relates to financial statement disclosures. Materiality is considered information that a reasonable investor would deem important in determining whether to purchase a security. In the ESG realm, there is an ongoing debate about what is material to determine which ESG factors a firm should target and disclose to investors. Discussion around what constitutes materiality is analogous to discussion about what constitutes ESG—companies have discretion over what to include in both. Arguably, material disclosures might have less discretion. Some proponents of ESG disclosure have stated that focusing on financial materiality would be most helpful to investors.

Financial materiality, as defined by the Sustainability Accounting Standards Board, “make the disclosure of financially material information more decision-useful by enhancing the extent to which those disclosures are reliable, consistent across time, and comparable across peers.”

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 or nuclear energy) would probably be more relevant.

While the Trump Administration has changed—and might continue to change—many of the existing requirements through executive orders or agency rulemaking, Congress, investors, and other stakeholders might consider whether a company is following the federal and local statutory requirements. In addition, stakeholders might consider if a company’s ESG issues can be addressed through the existing regulatory regime.

Issues for Congress

There is an ongoing debate within Congress about ESG disclosure requirements. Part of this debate centers on the SEC’s ability to require ESG disclosures and materiality.

Securities and Exchange Commission

Under the Trump Administration, the SEC, which oversees corporate financial reporting and disclosure requirements, ended its defense of its previously required climate change disclosure requirements for publicly listed companies. The climate change disclosure requirement was under judicial review.

While some publicly traded companies have issued statements or have changed their approaches to ESG issues,

their stances on ESG issues appear to have a broad range. Some may have less emphasis on DEI yet still publicly communicate their approach to climate change and other factors.

Proponents of ESG disclosures in SEC filings argue that investors might positively perceive a company that includes additional ESG disclosures in its SEC filings, as it may help address potential long-term risks. If identifying, disclosing, and addressing long-term risks results in a lower cost of capital, a company could achieve better financial results.

Critics, including current and former SEC commissioners, argue that existing regulations already address many ESG issues, and financially material ESG issues are required to be disclosed under the current SEC requirements. Given this, they assert that other disclosures should be voluntary and at the firm’s discretion. 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 that companies should focus on shareholder value and that some ESG proposals would distract from that goal.

Consistency of disclosures is another area of concern. Public companies discuss material ESG-related issues in their annual financial reports’ Management Discussion and Analysis (MD&A). Any ESG issues discussed in the MD&A section are generally not subject to an independent audit. Companies may also issue separate reports or provide ESG information on their company websites. 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.

Congress

In the 118th Congress, some Members introduced bills in support of and against ESG. Among them, a comprehensive ESG-related bill, H.R. 4790, Prioritizing Economic Growth Over Woke Policies, was passed in the House. Among other provisions, the bill would have required the SEC to consider the materiality of the disclosure requirements when issuing rules.

In the 119th Congress, some Members have introduced bills that cover a range of ESG issues. Among them, H.R. 257, the SEC Act of 2025, would prohibit the SEC from requiring issuers of securities to make climate-related disclosures that are not material to investors.

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