Section 4: Policymakers' ESG Concerns Should Not Override the Market's Allocation of Resources

The U.S. financial system is the means by which capital resources are allocated. At its most basic, borrowers, lenders, and investors exchange funds to finance projects and pursue a return on their financial assets. The market allocates funds based largely on the returns that the parties to the transactions expect to earn on their investments. In this way, "good" projects—those that provide goods or services that are desirable—get funded and "bad" projects generally do not. While this process is not perfect, over time the incentives and signals provided by the market generally allocate scarce capital resources efficiently.

The market's allocation of capital resources, however, is threatened by the encroachment of regulations and policies that seek to enshrine environmental or social policy into the financial system's framework. This encroachment not only undermines the efficient allocation of capital and risks undermining growth and innovation, but it also represents an abuse by financial regulators who are not tasked by Congress (or voters) to implement environmental or social policy and who lack the necessary expertise to create such policy.

Congress can take action to ensure that financial regulators do not function as central planners deciding which enterprises are worthy of capital, including by clarifying the scope of mandatory securities disclosures and shrinking bank regulators' responsibilities.

THE PROBLEM

From public company disclosures to the regulation of bank capital, financial regulators have increasingly been seeking to implement environmental or social policy through the financial system's allocation of capital. Climate change policy is a priority for the Biden administration, which has called climate change a "systemic risk to our economy and our financial system," saying that "we must take decisive action to mitigate its impacts."[1] Those actions include Treasury Secretary Janet Yellen's announcement that she would start a climate hub within the Department of the Treasury to coordinate "wide-ranging efforts to fight climate change through economic and tax policies" and "focus on financing for investments needed to reduce carbon emissions."[2] The Securities and Exchange Commission (SEC) has already proposed wide-ranging climate-related disclosures for public companies and is preparing proposals on corporate board diversity and human capital management, which may include disclosures related to worker demographics and benefits. These types of regulation can place a drag on the economy by imposing high costs while inappropriately turning financial regulators into universal policymakers.

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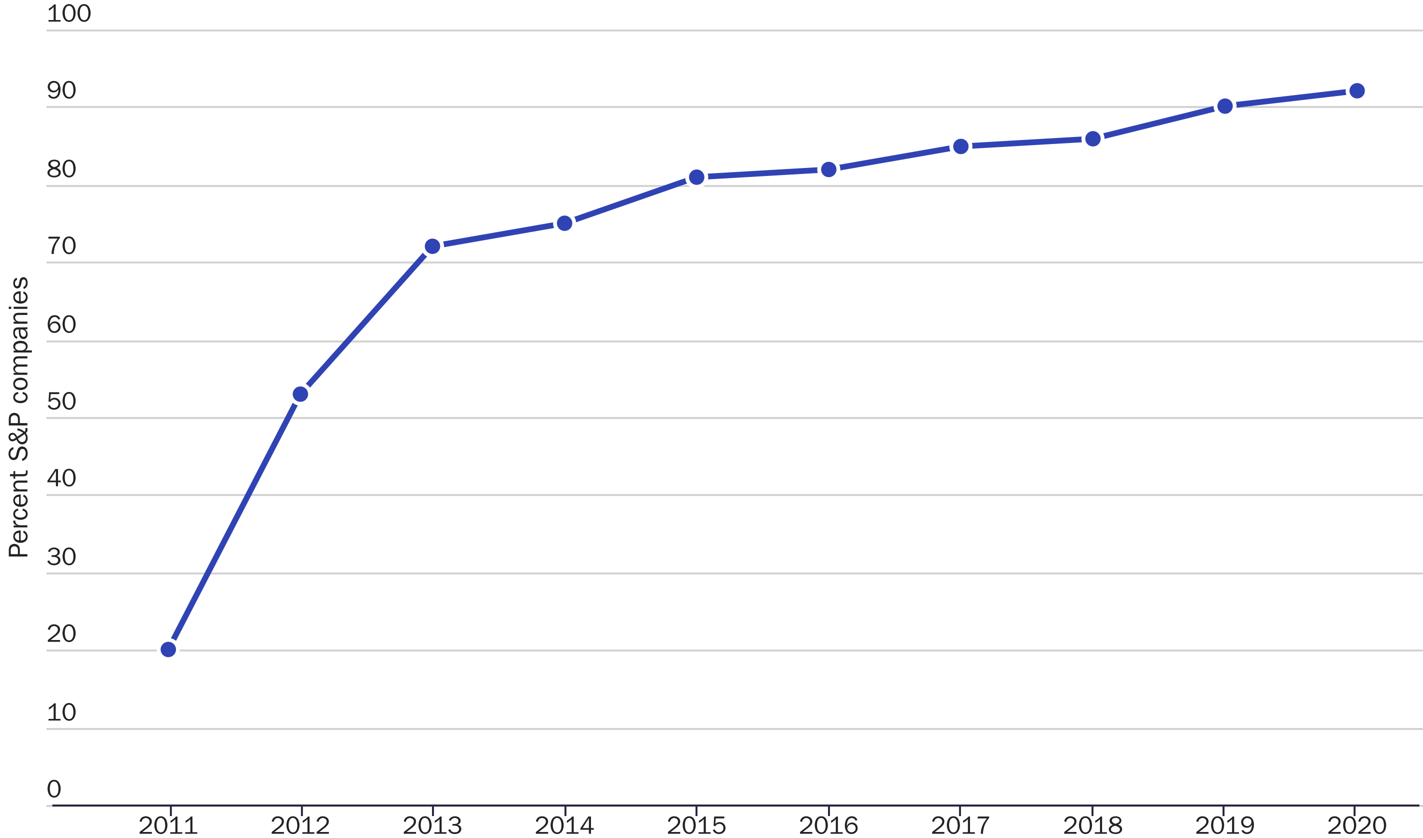
Take, for instance, public company disclosures, which are meant to provide investors with information about a company's financial prospects. Public companies' mandatory disclosures have expanded in recent years, at times serving as vehicles to promote extraneous policy goals. The Dodd–Frank Act requires companies to report on the origin of certain "conflict minerals" used in their products and to disclose the ratio of the CEO's pay to the company's median employee. This expansion is poised to continue as

Figure 4

Over 90 percent of S&P 500 companies already publish sustainability reports or disclosures



Source: "2021 Sustainability Reporting in Focus," Governance & Accountability Institute Inc., December 2021.

the SEC's agenda contains new mandatory public disclosures for a wide variety of information related to what is called "ESG" investing, meaning strategies or theories that take into account a company's environmental, social, and governance factors when making an investment decision. Notably, more than 90 percent of the largest U.S. public companies already publish sustainability disclosures without the SEC's mandate (see Figure 4).

Disclosures relating to climate change, board and workforce diversity, and corporate political contributions, among other things, stray far from the existing securities regulation framework of providing information relevant to price discovery. This expansion is problematic. If the SEC's disclosure regime becomes untethered from its price-discovery function, it can be bent to any purpose. Americans should feel secure that any disclosures the government requires are carefully cabined to encompass only information directly related to the legislation's initial intent. These disclosures also often have unintended consequences, particularly where the purpose of the disclosure is to drive non-securities-related policy change.

The banking sector similarly suffers when inappropriate policy aims drive the regulation of banks. Precedent already exists for federal officials using bank regulations to allocate credit to further political goals, including to discourage payday lending and to hinder financing for gun dealers. It is entirely plausible that federal officials could soon repeat such actions, disfavoring those firms in industries that disturb certain political sensibilities (such as fossil fuels and nonorganic agriculture) by limiting access to banking services and payment systems.

Many federal agencies can influence bank activities through the federal regulatory framework, potentially imposing climate change–related regulations through the examination process (among other ways), whether citing concerns over capital adequacy, reputational risks, or even systemic risks. Regulators have a great deal of discretion in these cases, and banks have very little recourse. For example, the Federal Deposit Insurance Corporation can terminate a bank's status as an insured depository institution if it finds that the bank has engaged in "unsafe or unsound practices," and the agency alone is responsible for determining what constitutes unsafe or unsound practices. Moreover, when regulators determine that an insured depository institution has engaged in an unsafe or unsound practice, they have the explicit legal authority "to place limitations on the activities or functions of an insured depository institution or any institution-affiliated party."[3] Overall, bank regulators have enormous flexibility to develop regulations for anything that they deem a risk factor, including climate change, and banks will be very hesitant to push back against these requirements.

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SOLUTIONS

Congress should undertake several reforms to protect the market's allocation of capital from distortion introduced by financial regulation of environmental and social causes.

- **Clarify scope of mandatory securities disclosures.** Although the scope of disclosures under the Securities Act of 1933 and the Securities Exchange Act of 1934 has long been understood to encompass information necessary for investors to value securities—primarily a company's financial performance and information about its business—the heated debate about the SEC's authority to promulgate climate risk disclosures indicates that a clear delineation of this scope is necessary. Congress should clearly state that disclosures are limited to the type of information relevant to a company's prospects for financial success, as originally contemplated by the 1933 and 1934 acts, and repeal the sections of the Dodd–Frank Act that direct the SEC to promulgate the conflict minerals and pay-ratio disclosure rules.
- **Exercise strong congressional oversight of the SEC.** Even where the agency may have authority to promulgate rules that touch on environmental and social matters, Congress should exercise active oversight to ensure that the SEC is focusing its limited resources on advancing regulation related to its core mission.
- **Shrink and clarify bank regulators' responsibilities.** Congress should require banking regulators to consider solely economic and financial factors when promulgating regulations, rather than factors that might affect the public's view of a bank, including the bank's so-called reputational risks. More broadly, Congress should reassert its control over financial policy and reduce the regulatory authority and discretion of financial regulators. Repealing Title 1 of the Dodd–Frank Act, thus eliminating the Financial Stability Oversight Council, would be one step in a positive direction. Congress should explicitly prohibit banking regulators from considering social or political objectives, including climate change, in the supervision and examination of banks or credit unions regarding assets rating, capital adequacy, reputational risk, lending limits, "prudential" standards, and financial stability.

SUGGESTED READING

Public Comment re: The Enhancement and Standardization of Climate-Related Disclosures for Investors by Jennifer J. Schulp, Thomas A. Berry, and William Yeatman, Public Interest Comment, June 17, 2022.

The SEC's Green Name Game by Jennifer J. Schulp, *National Review (Online)*, January 14, 2022.

"**Securities Regulation**" in ***Cato Handbook for Policymakers***, 9th ed., by Jennifer J. Schulp, Washington: Cato Institute, forthcoming.

Wide World of ESG: Understanding Investor Demand by Jennifer J. Schulp, *Alt-M*, July 28, 2021.

Using Financial Regulation to Fight Climate Change: A Losing Battle by Norbert J. Michel, David R. Burton, and Nicolas D. Loris, Heritage Foundation Backgrounder no. 3634, June 24, 2021.