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Predictions for ESG in 2023: Stronger regulations and intensifying competition will fail to end sustainable investing boom

Article

The predictions: The rise of environmental, social, and governance (ESG) investing has continued in 2022 due to surging consumer demand which is helping to accelerate uptake among banks and money managers.

We take a look at what the next year could hold for sustainable finance and ESG.

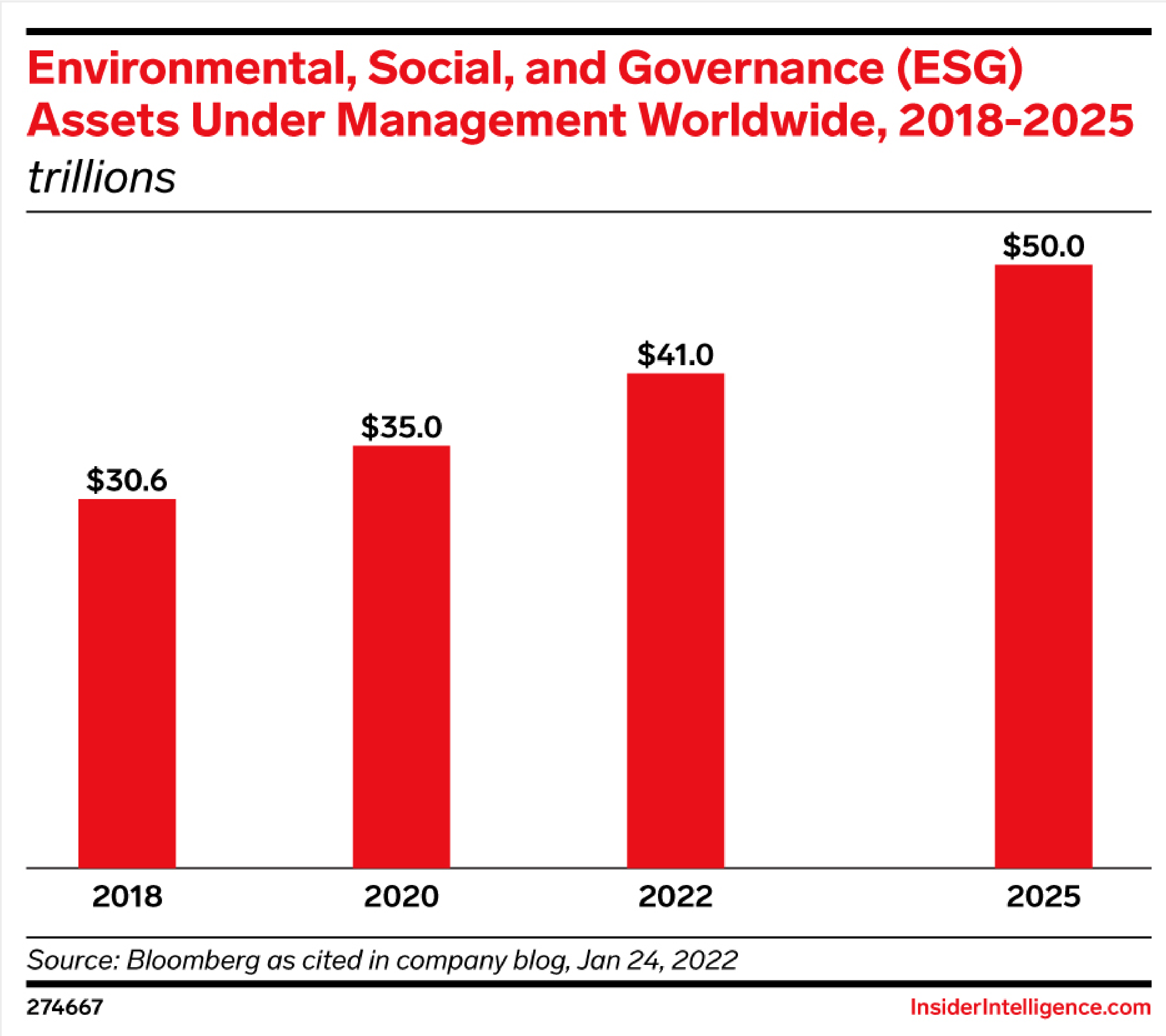
The ESG investing boom will accelerate, but the sustainable fund market could shrink. As investors, asset managers, and banks recognize the value in ESG, more will prioritize it.

- When asked, **81% of institutional investors in the US said they plan to increase their allocations to ESG products** over the next two years, per a PwC report. And 83% of those in Europe said the same.
- US-based institutional investors and money management firms with sustainability strategies named **climate change and carbon emissions as their top priority**, with each group saying it applied to more than $3 trillion of the assets they control, per industry association US SIF.
- About two-fifths (41%) of banking executives globally selected **ESG among their organizations' greatest opportunities**, according to Economist Impact research sponsored by analytics firm SAS.

Financial institutions recognize that much of the labor force want to work for firms with strong ESG policies and that consumers also care: **One in four said they'd leave their bank over poor environmental and social track records**, per Kearney data.

For asset managers, swelling client demand for ESG products will keep sustainable investing as a priority and drive growth through 2025. And green investing is likely to gradually mature in the coming years as a "generational shift" in wealth management occurs.

However, stronger scrutiny of ESG will force some asset managers to reevaluate funds' labels, causing the overall market to contract. And fears of being accused of greenwashing will force banks and FIs to exercise caution around how they market new funds—meaning total ESG products could decrease despite rising demand.



Stronger oversight is coming. Regulatory pressures around ESG are building on both sides of the Atlantic.

- In the US, the **Securities and Exchange Commission (SEC)** has been cracking down on misleading ESG claims, including a $4 million fine for **Goldman Sachs** and $1.5 million penalty for **BNY Mellon**. Expect this to continue in the run up to more concrete US regulatory standards on ESG, which is likely to be complicated by political headwinds.

- New rules overseeing ESG investing in the EU were finalized in August. Confusion among asset managers about how they classify ESG products could lead to more financial punishments as watchdogs investigate possible infringements. Rules may also be amended to improve clarity.
- New regulations are edging closer in the UK. The government this month committed to updating a Green Finance Strategy in early 2023 and to hold talks about ESG ratings providers into regulations.

More truth in labels. Banks are becoming more conscious of what they label as ESG. Lenders will be desperate to avoid the reputational and financial damage caused by fines for greenwashing as part of the SEC's crackdown.

Asset managers are also under pressure to rethink what constitutes ESG:

- **US assets under management (AuM) totaled $8.4 trillion at the start of 2022**, per US SIF. That's less than half the $17.1 trillion reported for 2020. The sharp drop is mostly driven by stricter conditions around what is classed as ESG.
- It's a similar story in Europe: There's been a surge of ESG fund downgrades after new regulations came into force. **More than $100 billion in AuM is estimated to have been downgraded** so far, per Bloomberg News, with **BlackRock** and **Amundi** among those reclassifying funds.

Expect more clarity from the SEC around what should be classed as ESG; it's already proposed changes to its names rule. Regulators in the EU will also want to clean up any confusion around ESG fund labels. Banks and asset management firms will become more cautious about what they class as ESG and be forced to self-regulate to dodge the threat of watchdog punishments. This will contribute to a likely drop in total ESG AuM.

The competitive advantage that ESG gives will shrink. The edge that ESG products can generate for wealth management firms is diminishing as the trend becomes the norm: ESG assets are on pace to constitute 21.5% of global AuM in less than five years, per PwC.

Simply offering green investing won't be enough in the long term to attract and satisfy clients, although it can still give asset managers a short-term advantage. That means fund managers will be forced to differentiate through the performance of ESG funds, particularly as the bear market squeezes returns. With watchdogs and investors becoming more critical about greenwashing and growth no longer guaranteed, asset managers need to do more to prove funds' worth.

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