MSCI

Funds and the European Sustainable Finance Landscape 2024

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Contents

Key takeaways:

- **Sustainability-related funds represented the majority of European fund assets** (around EUR 8 trillion out of EUR 14 trillion), mainly through equity and bond funds. Global equity strategies were popular among SFDR article 8 and 9 funds. **Article 9 fund choice remains limited,** however, by asset class, region and sector, **creating opportunities for differentiation in fund launches.**

- More than twice as many European-domiciled funds have over 5% taxonomy-aligned capital expenditure (capex) exposure versus aligned revenues, indicating **European funds' exposure to green revenues should rise as companies invest in more sustainable activities.** This could indicate **growing momentum toward green revenues.** Taxonomy-eligible revenues also far exceeded aligned revenues, pointing to a higher likelihood of further alignment.

- **Exchange-traded funds (ETFs) focused on utilities reported the highest taxonomy alignment** due to renewable-energy activities. **This included funds without a sustainability objective (article 6), potentially signaling a broader market shift toward sustainability.** The **European utilities sector** is also **well placed to play a role in transition finance,** with over 60% of its investment activity already taxonomy-aligned — a key consideration for transition-based fund strategies.[1]

- **Article 8 funds returned to net inflows in H1 2024 of EUR 44 billion, with fund selectors continuing to favor indexed products.** Outflows from article 9 strategies persisted, led by active funds. As of June 30, 2024, assets under management (AUM) for article 8 and 9 funds reached EUR 6.9 trillion and EUR 330 billion, respectively.

- **Fund disclosures improved, with triple the number of funds submitting data in the European ESG Template (EET) compared to 2023.** Eighty percent of funds indicated they considered the Principal Adverse Impact (PAI) indicators from the Sustainable Finance Disclosure Regulation (SFDR) in their investment strategy, up from 50% in 2023. **Changes to PAIs in future SFDR updates could therefore have far-reaching implications for EU based funds' investment strategies and their continued alignment with clients' sustainability preferences.**

- **Green bond and infrastructure funds are particularly impacted by the European Securities and Markets Authority's (ESMA) fund-naming rules.** A quarter of article 9 funds with high fossil-fuel exposure include "green bonds" in their names, which are subject to fossil-fuel exclusions based on the EU's Paris-Aligned Benchmark (PAB). Infrastructure funds will also need to change names to avoid significant divestment impacts. **Since ESMA's guidance in May 2024, we have seen a decline in article 8 and 9 funds using more-stringent sustainability-related terms.**

- **Our analysis showed marked differences in PAB alignment across major indexes,** on an asset class and geographic basis, **which could influence fund managers (i) defining sustainability mandates and (ii) identifying eligible investments from a portfolio-construction perspective.**

- **We found around 320 U.K.-domiciled funds in scope of the Sustainability Disclosure Requirements' (SDR) fund-labeling rules, with AUM totaling only GBP 175 billion.** Using MSCI's definition of Sustainable Investments (SI) under SFDR Article 2(17), only six funds have a minimum of 70% in SI, indicating significant room for improvement.

1 Sector definitions are based on the Global Industry Classification Standard (GICS®), jointly developed by MSCI and S&P Global Market Intelligence.

Introduction

In this paper, we assess how European-based funds have performed under key regulatory disclosure regimes and provide insights into their sustainability characteristics, including SFDR article 8 and 9 funds. We assess to what extent reported fund data has improved under the EU Taxonomy, following the first year of corporate disclosures in 2023, and the level of taxonomy-alignment across the European funds universe. We also evaluate ESMA's new fund-naming guidance in Europe alongside the SDR in the U.K. Finally, we discuss recent opinions from regulatory bodies such as the European Supervisory Authorities (ESAs).[2]

Over the past year, there have been numerous developments in the European sustainable-finance landscape, from EU Taxonomy disclosure requirements to the introduction of the Corporate Sustainability Reporting Directive (CSRD) to new fund-naming/labeling regimes across Europe. The CSRD extends the scope and reporting requirements of the Non-Financial Reporting Directive (NFRD) and its introduction should improve the availability of issuer data when reporting begins in 2025, helping provide greater insights and transparency for investors at the fund level. The Corporate Sustainability Due Diligence Directive (CSDDD) was also adopted this year as part of recent EU legislation aimed at improving supply-chain due diligence and transparency. The EU Deforestation Regulation (EUDR) is an extension of this spotlight on value chains. There has also been a renewed focus on biodiversity with the introduction of the Taskforce on Nature-related Financial Disclosures (TNFD) framework in September 2023, which fund managers can use to develop strategies that integrate nature-related risks.[3]

Regulators have also looked to address the limitations of current regulatory frameworks and mitigate greenwashing concerns. As part of this, the European Commission consulted on the SFDR in 2023 and its review is ongoing. In May of this year, ESMA published its guidelines on fund names using ESG- or sustainability-related terms, which seeks to ensure fund names accurately represent products' sustainability characteristics.[4] The U.K.'s Financial Conduct Authority (FCA) also published its SDR, including a fund-labeling regime, in late 2023.[5]

2 The ESAs are the EBA, ESMA and the European Insurance and Occupational Pensions Authority (EIOPA).

3 The TNFD is an international market-backed reform, rather than being regulatory led.

4 "Final Report — Guidelines on funds' names using ESG or sustainability-related terms," ESMA, May 14, 2024.

5 "Sustainability Disclosure Requirements (SDR) and investment labels," FCA, Nov. 28, 2023.

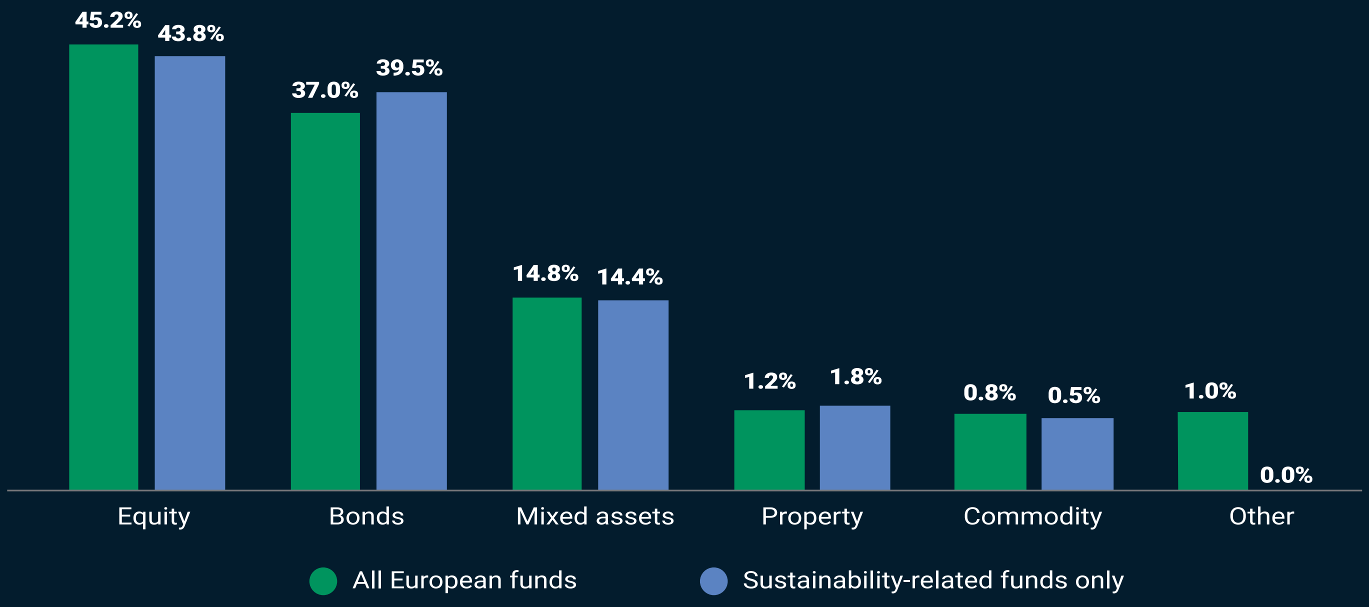
The European **funds market**

Since the publication of last year's paper, the market for European funds has continued to grow against a backdrop of rising investment markets. By the end of June 2024, European-domiciled funds accounted for EUR 14 trillion in AUM across nearly 38,000 funds.[6] The number of active versus passive funds in Europe has remained stable (90% vs. 10%), while the share of assets in passive funds is disproportionately higher at 25% of AUM. Sustainability-related funds continued to represent a significant portion of European fund assets, with AUM growing to around EUR 8 trillion, the majority being invested in equity (44%) and bond (40%) strategies.[7] The split of AUM by asset class is broadly similar for all European funds versus sustainability-related funds only.

6 Approximately EUR 3 trillion is held in money-market funds.

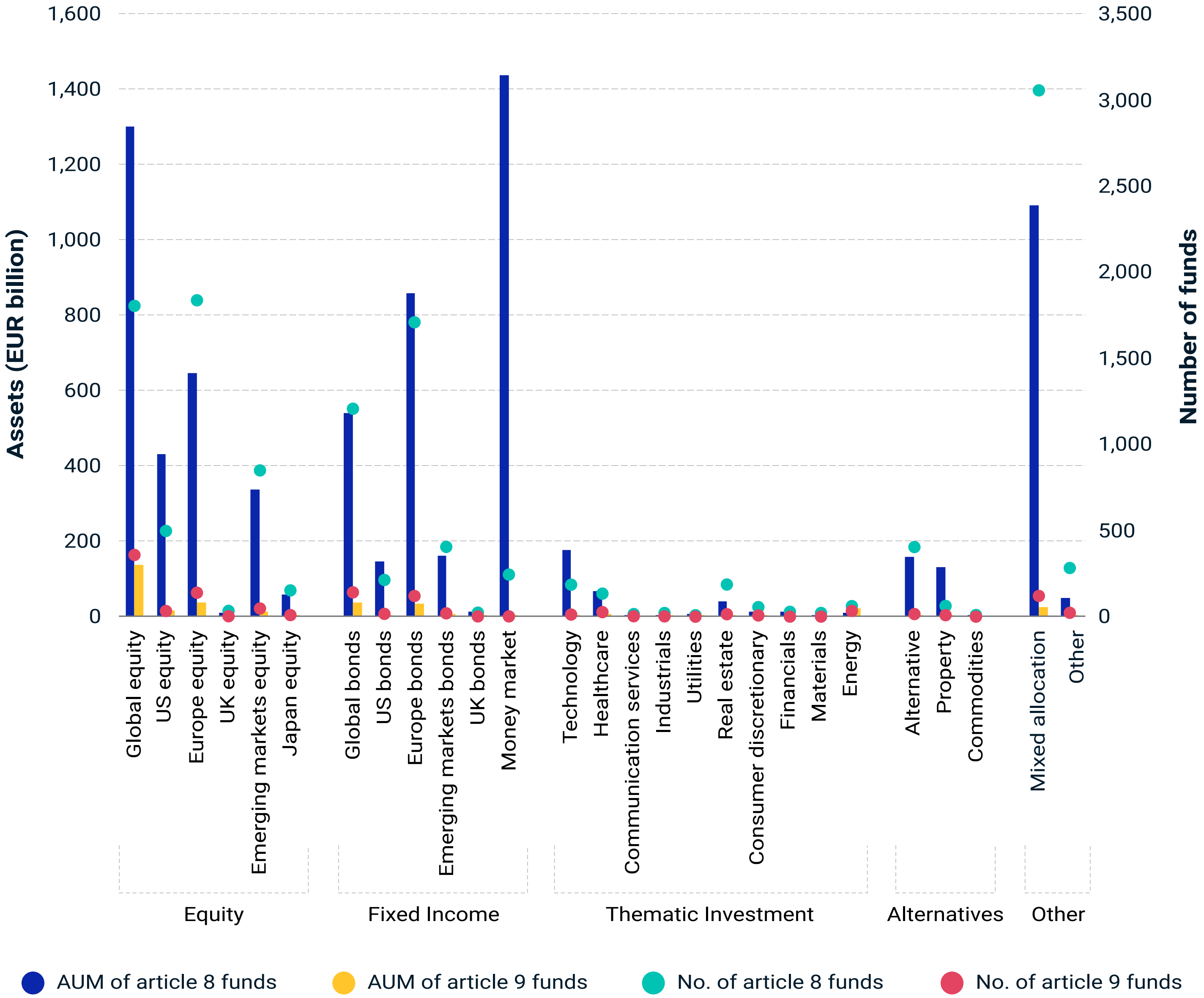
7 Sustainability-related is defined as funds that employ any ESG or sustainability-related consideration in the investment process (e.g., exclusions, integration, engagement, best-in-class, positive screening, impact investing and sustainability/thematic investing).

Exhibit 1: Breakdown of European funds' AUM by asset class



Data as of June 30, 2024. All European funds (*n* = 37,686) and sustainability-related funds only (*n* = 16,171). Source: MSCI ESG Research, Broadridge

Exhibit 2: Investor choice remains plentiful in article 8 funds



Data as of June 30, 2024. Article 8 funds (*n* = 13,481) and article 9 funds (*n* = 1,122). Asset class and sector categories are based on Morningstar classifications. Source: MSCI ESG Research

Looking at European sustainability-related funds through the lens of SFDR (Exhibit 2), global-equity mandates are popular among article 8 and 9 funds, representing 20% of assets. Meanwhile, money-market and fixed-income strategies may have attracted assets due to higher interest rates. In contrast to article 8 funds, investor choice across article 9 strategies remains limited, likely due to stricter regulatory standards. For example, article 9 funds with an energy focus shed EUR 8 billion in the year to June 2024, the most of any sector. The lack of investment options in article 9 funds, however, does create opportunities for new fund launches, particularly in thematic strategies.

EU Taxonomy — low alignment, but on the rise

In the second half of 2023, the European Commission published its final guidance on the remaining four environmental objectives of the EU Taxonomy: Sustainable Use and Protection of Water and Marine Resources, Transition to a Circular Economy, Pollution Prevention and Control, and Protection and Restoration of Biodiversity and Ecosystems.[8] Nonfinancial companies only began reporting taxonomy eligibility for these objectives in 2024 (Exhibit 3). Overall, there was a notable increase in the number of funds reporting taxonomy metrics, with taxonomy-alignment figures modestly rising, albeit from a low base (Exhibit 4).

Exhibit 3: Reporting timelines under the EU Taxonomy

Reporting period	Based on financial year	Reporting metrics
As of January 2023	2022	Nonfinancial entities report taxonomy eligibility and alignment. Financial entities report taxonomy eligibility. (Applicable for Climate Change Adaptation and Climate Change Mitigation only)
As of January 2024	2023	Financial entities report taxonomy eligibility and alignment. (Applicable for Climate Change Adaptation and Climate Change Mitigation only) Nonfinancial and financial entities report taxonomy eligibility. (Applicable for four additional environmental objectives)
As of January 2025	2024	Nonfinancial entities report taxonomy eligibility and alignment. Financial entities report taxonomy eligibility. (Applicable for four additional environmental objectives)
As of January 2026	2025	Financial entities report taxonomy eligibility and alignment. (Applicable for four additional environmental objectives)

Further information is available in the MSCI EU Taxonomy Reported Data User Guide. Source: MSCI ESG Research

Reported EU Taxonomy data is now available after the first full year of issuer disclosures in 2023, though coverage is limited. For context, MSCI's EU Taxonomy coverage universe at the company level was approximately 12,000 equity and fixed-income issuers (as of December 2023), including around 9,000 equity-issuer constituents of the MSCI ACWI Investable Market Index (IMI). In 2023, approximately 2,000 issuers under coverage were in scope of NFRD and therefore required to disclose EU Taxonomy key performance indicators (KPIs). An additional 100+ issuers voluntarily disclosed taxonomy data. As disclosure requirements expand to a wider group of issuers under CSRD (and other jurisdictions develop their own taxonomy reporting frameworks in time),[9] we may see further improvements in data availability. For now, the first year of reported taxonomy data offers a new reference for assessing the sustainability characteristics of European funds.

8 "Commission Delegated Regulation (EU) 2023/2486 of 27 June 2023 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council," Official Journal of the European Union, Nov. 22, 2023.

9 Fiona Stewart, Louise Gardiner and Aaron Levine, "Taxonomy astronomy: The global search to define sustainable finance," World Bank Blogs, June 6, 2024.

At the fund level, we observed an improvement in voluntary taxonomy disclosures in the EET, with the proportion of funds reporting aggregated KPIs increasing by 30% in the year to June 2024 (Exhibit 4).[10] Based on EET funds data, average reported taxonomy alignment remains low, but increased modestly versus last year, particularly for KPIs based on capex and operational expenditures (opex). This reflects better issuer-level disclosures, as discussed previously, and possibly funds with stronger KPIs choosing to promote their sustainability characteristics.

Exhibit 4: EET taxonomy disclosures have improved

		June 2023			June 2024		
		Overall EET	**Article 8**	**Article 9**	**Overall EET**	**Article 8**	**Article 9**
Average reported EU Taxonomy aligned KPI*	**Turnover (%)**	5.0%	4.3%	10.7%	5.3%	4.7%	10.1%
	Capex (%)	4.6%	4.2%	7.6%	5.6%	5.1%	7.7%
	Opex (%)	3.4%	3.2%	4.2%	4.9%	4.6%	5.1%
KPI coverage		38%	58%	61%	68%	74%	79%

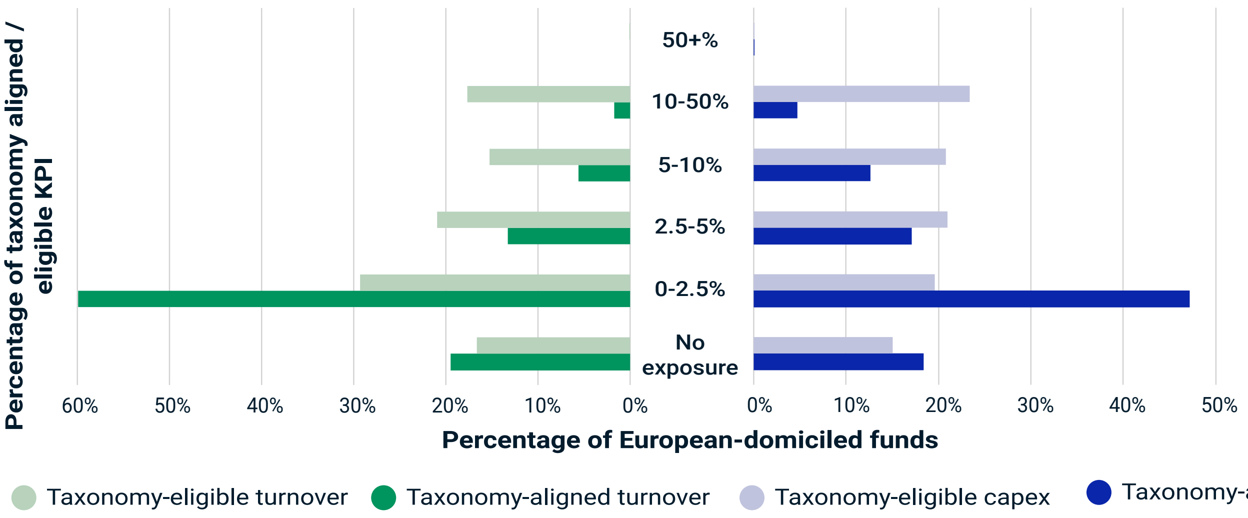
Data as of June 30, 2024. EET version 1.1.1. was used for June 2024 data. * Includes funds with a reported KPI above zero, for comparison purposes. Source: MSCI ESG Research, EET disclosures

Given that EET fund disclosures are self-reported on a voluntary basis, we also evaluated taxonomy data for funds within MSCI's coverage. We found less than 10% of European-domiciled funds had exposure to more than 5% taxonomy-aligned revenue (limitations in issuer disclosures are a mitigating factor). There were signs, however, that alignment to sustainable activities could increase in future:

- More than twice as many funds had over 5% exposure to taxonomy-aligned capex versus revenues. Capex is a strong forward-looking indicator, suggesting European funds' exposure to green revenues should rise as companies invest in sustainable activities. This could signal growing momentum toward more-sustainable investments and a greener economy.
- Taxonomy-eligible revenues also far exceeded aligned revenues, pointing to a higher likelihood of further alignment. Nearly a fifth of European-domiciled funds had exposure to issuers with eligible activities between 10% and 50% of revenues.

By asset class, MSCI ESG Research data showed taxonomy alignment to be similar for equity and bond funds, although taxonomy eligibility was higher for equity funds.

Exhibit 5: EU Taxonomy-eligible and -aligned activities for European-domiciled funds



Data as of July 31, 2024, *n* = 27,267. Aggregated fund factors are based on long-only total portfolios (including sovereign investments). Reported taxonomy data is for nonfinancial companies. Source: MSCI ESG Research

10 The EET is a standardized reporting framework for asset managers and fund distributors to disclose ESG-related funds data and support compliance with regulatory requirements. Submissions are voluntary.

Exhibit 6: Funds with the highest levels of reported taxonomy alignment

Fund name	Investment type	Asset class	SFDR	Alignment (revenue-based)	Alignment (capex-based)
SPDR MSCI Europe Utilities ETF	ETF	Equity	Article 6	33%	66%
Xtrackers MSCI Europe Utilities ESG Screen ETF	ETF	Equity	Article 8	34%	64%
Invesco STOXX Europe 600 Optimised Utilities ETF	ETF	Equity	Article 6	33%	64%
iShares STOXX Europe 600 Utilities ETF (DE)	ETF	Equity	Article 6	32%	64%
Vontobel Fund – Green Bond	Mutual fund	Bond	Article 9	33%	48%
Sycomore Environmental Euro IG Corporate Bonds	Mutual fund	Bond	Article 9	31%	46%
Mutuafondo Transicion Energetica FI	Mutual fund	Equity	Article 8	37%	42%
Global X Wind Energy ETF	ETF	Equity	Article 8	38%	41%

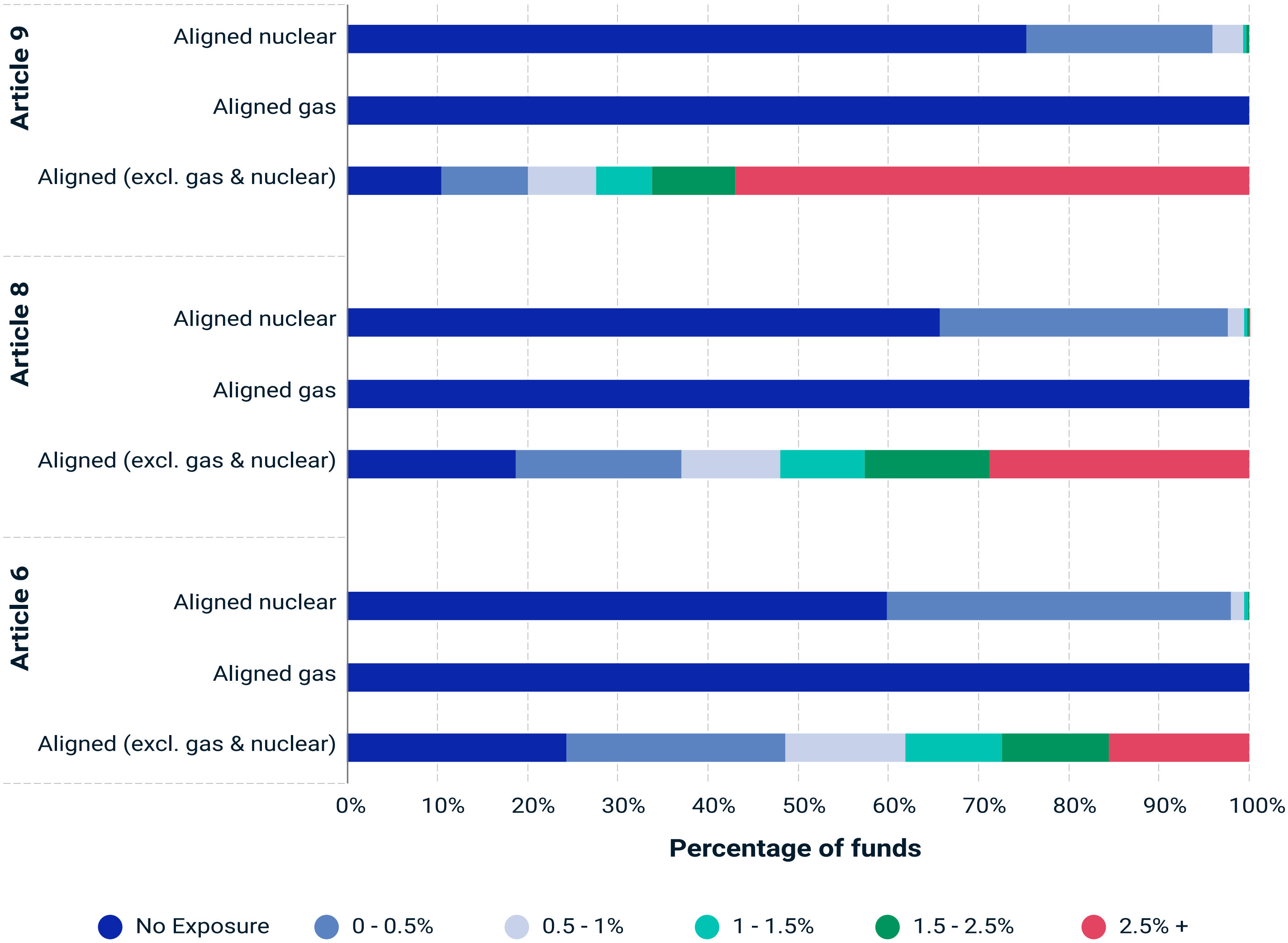
Data as of June 30, 2024. Aggregated fund factors are based on long-only total portfolios (including sovereign investments). Reported taxonomy data is for nonfinancial companies. Source: MSCI ESG Research

Across MSCI's coverage universe, we assessed which funds reported the highest revenue and capex taxonomy-alignment. Eight funds were common to both top 10 lists and the majority were utility-focused equity ETFs. Renewable energy accounts for much of the taxonomy alignment and even appears in funds with no stated sustainability objective (article 6), potentially signaling a broader market shift toward sustainability. It also highlights the mainstreaming of renewable-energy investing — not only playing a crucial role in the energy transition from an impact perspective, but also providing an investment opportunity for funds beyond sustainability mandates. The European utilities sector is also well placed to play a role in transition finance, with over 60% of its investment activity (capex) already taxonomy aligned (Exhibit 6), as the sector shifts away from legacy fossil-fuel activities – a key consideration for transition-based fund strategies.

In contrast, alignment with sustainable gas and nuclear activities remains low, reflecting strict technical screening criteria in the taxonomy. Based on MSCI's coverage, European-domiciled funds reported no revenue exposure to taxonomy-aligned gas activities, despite industry concerns that taxonomy inclusion would encourage capital flows to gas-powered energy generation.[11] Our analysis shows small revenue exposure to aligned nuclear activities, typically less than 1% (Exhibit 7). Aligned capex tells a similar story, suggesting sustainable gas and nuclear activities are likely to play minor roles in future taxonomy alignment for investor portfolios.

11 Valentina Romano, "Campaigners sue EU for labelling gas sustainable," Climate Change News, April 18, 2023.

Exhibit 7: Taxonomy alignment for European funds, including nuclear and gas (revenue-based KPIs)



Data as of July 31, 2024, *n* = 15,345. Aggregated fund factors are based on long-only total portfolios (including sovereign investments). Reported taxonomy data is for nonfinancial companies. Source: MSCI ESG Research

Within sustainable finance, the concept of transition finance is gaining traction (i.e., transitioning toward more sustainable activities that are beneficial for the environment). The EU Taxonomy measures enabling-aligned and transitional-aligned activities with this in mind.[12] Based on reported data, our analysis found that over two-thirds of European-domiciled funds had exposure to activities with enabling-aligned revenues, though only 2% of funds had revenue exposure above 5%. Exposure to transitional-aligned revenues, however, was negligible, highlighting that transition finance is still in its infancy and would benefit from greater clarity on how transition is defined.

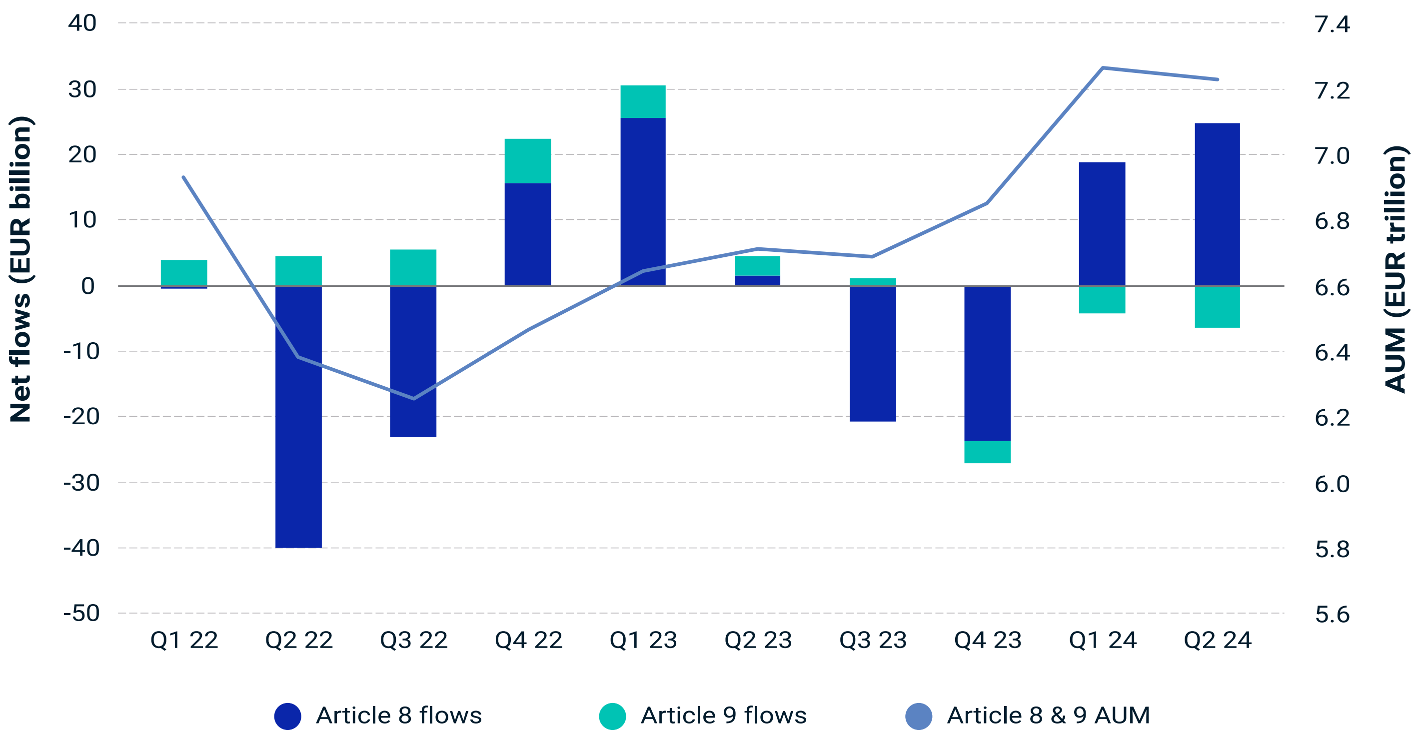
12 Enabling-aligned activities facilitate other activities to achieve emissions reductions or other environmental benefits (i.e., they support the broader transition to a sustainable economy and include, for example, solar-panel production or energy-efficiency technologies). Transitional-aligned activities are those that contribute to climate-change mitigation by transitioning to more-sustainable practices, often in high-carbon industries.

Sustainable Finance **Disclosure Regulation**

Article 8 and 9 fund flows

After a more challenging period in 2023 for sustainability-related funds, article 8 funds returned to net inflows in 2024, attracting EUR 43.5 billion in the first half of the year. Article 9 funds, however, experienced net outflows over this time, continuing the trend of the final quarter of 2023. As of June 30, 2024, article 9 AUM was a relatively modest EUR 330 billion versus article 8 assets of EUR 6.9 trillion. Article 8 funds also outnumber article 9 funds by a ratio of twelve to one.

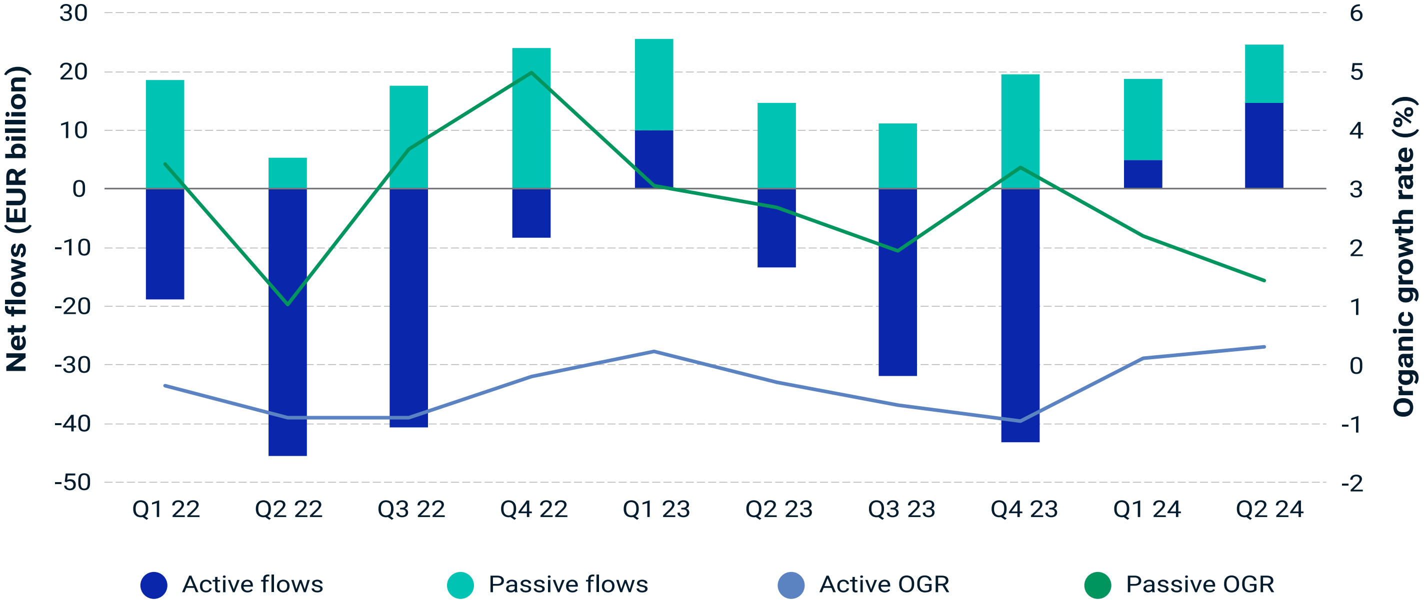
Exhibit 8: Net flows and AUM in Article 8 and 9 funds



Data as of June 30, 2024. Source: MSCI ESG Research

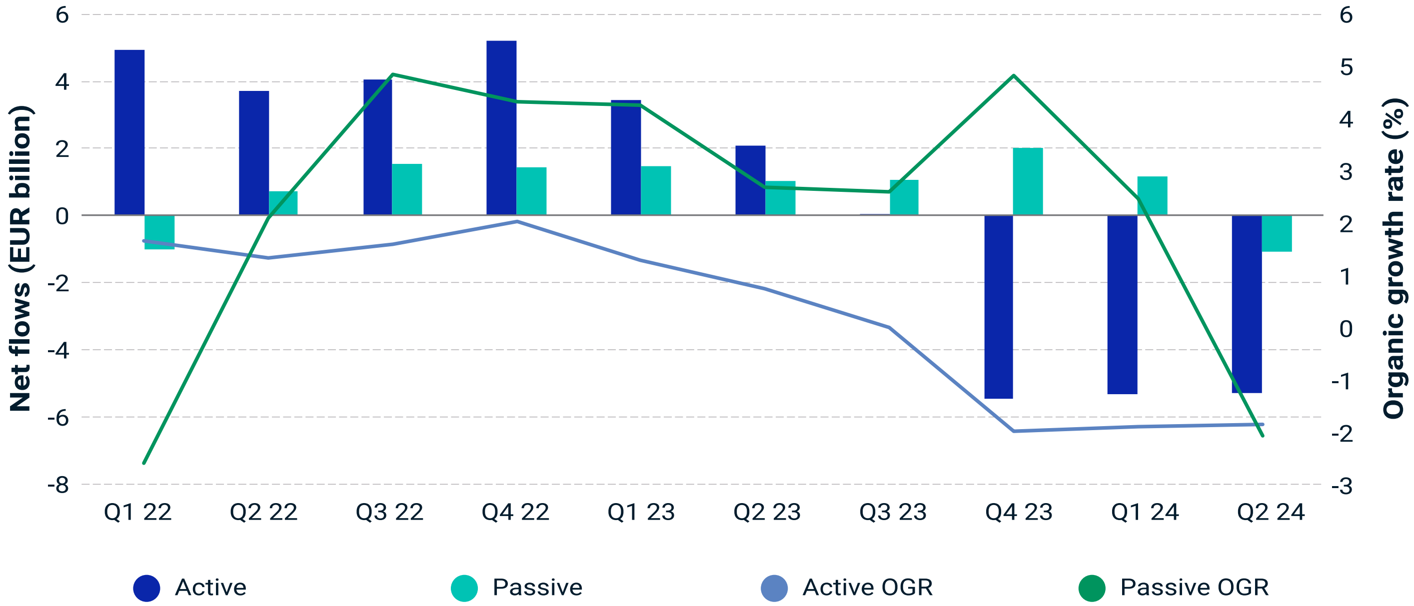
Fund selectors continue to favor indexed products for new sustainability investments. Passive article 8 funds led the way in attracting assets with consecutive quarterly inflows. Active article 8 funds were also in demand in H1 2024, with their first net inflows since Q1 2023. Article 9 outflows have primarily been focused on active funds (around EUR 15 billion in the past three quarters).

Exhibit 9: Net flows and growth rates in article 8 funds (by active and passive strategies)



Data as of June 30, 2024. OGR is organic growth rate. Source: MSCI ESG Research

Exhibit 10: Net flows and growth rates in article 9 funds (by active and passive strategies)



Data as of June 30, 2024. OGR is organic growth rate. Source: MSCI ESG Research

Based on our analysis for the first half of 2024, SFDR fund reclassifications eased, as fund managers possibly grew more comfortable with the regulatory guidance. Only five funds downgraded from article 9 to 8, in contrast to large numbers of downgrades in previous years. There was a net increase in article 8 classifications of 671 funds, suggesting new funds coming onto the market might be taking a more conservative approach to their sustainability claims. Article 9 saw a modest net increase of 60 funds, including 35 funds that reclassified from article 8.

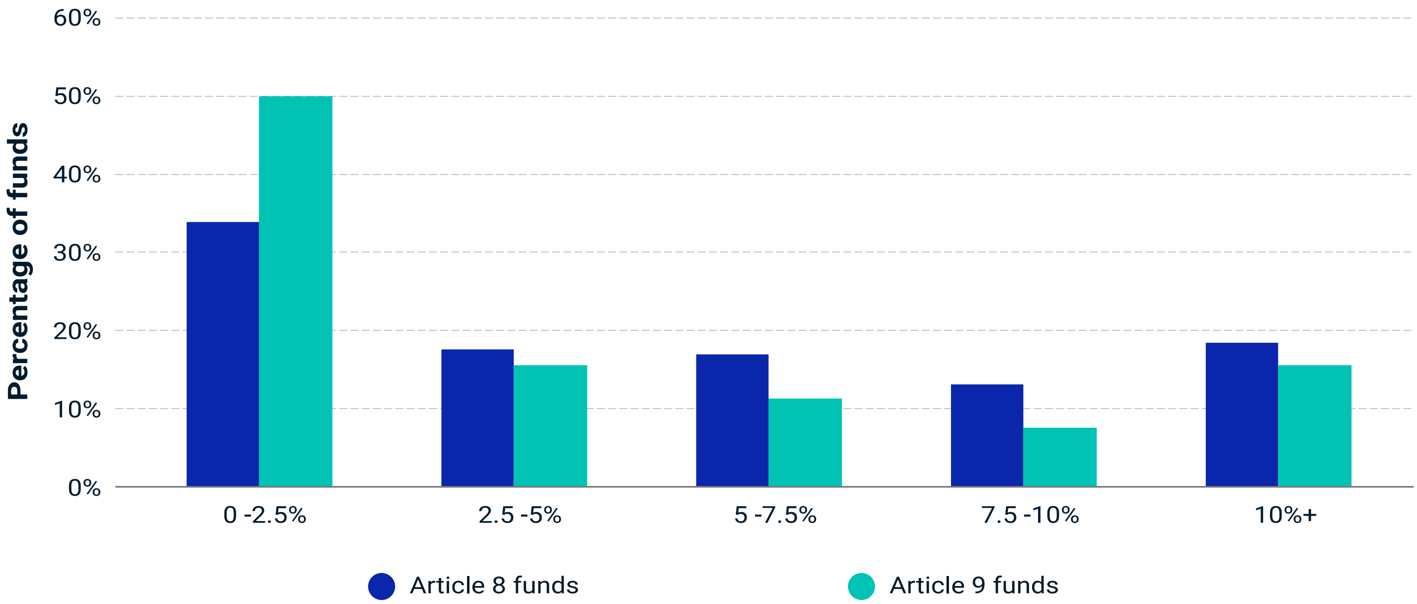
Principal Adverse Impact indicators

Within MSCI's coverage universe, funds with a sustainability investment objective had the lowest exposure to companies active in the fossil-fuel sector (PAI 4), with 50% of article 9 funds having negligible to no exposure to fossil-fuel companies. As fossil-fuel exposure rises, the percentage of funds included declines, except for exposures above 10%, which may appear counterintuitive. For article 9, this is due to funds investing in utilities, the energy transition and green bonds; in other words, companies with legacy fossil-fuel activities, those moving toward cleaner energy and/or raising capital for targeted green projects.

Our analysis revealed that a quarter of article 9 funds with high fossil-fuel exposure (>10%) include the term "green bonds" in their fund name, at odds with ESMA's new fund-naming rules. ESMA's guidance requires funds using environmental terms, such as green, to apply restrictive fossil-fuel exclusions based on the PABs. Given the growth in green-bond issuance since the EU Green Bond Standard was introduced, the current guidance is likely to have a significant impact on green-bond funds, which will need to change names or divest holdings. Several climate-bond funds are also impacted, based on our analysis. We assess the impact of MSCI's ESMA PAB screen in more detail later in the paper (see section "To rename or not to rename").

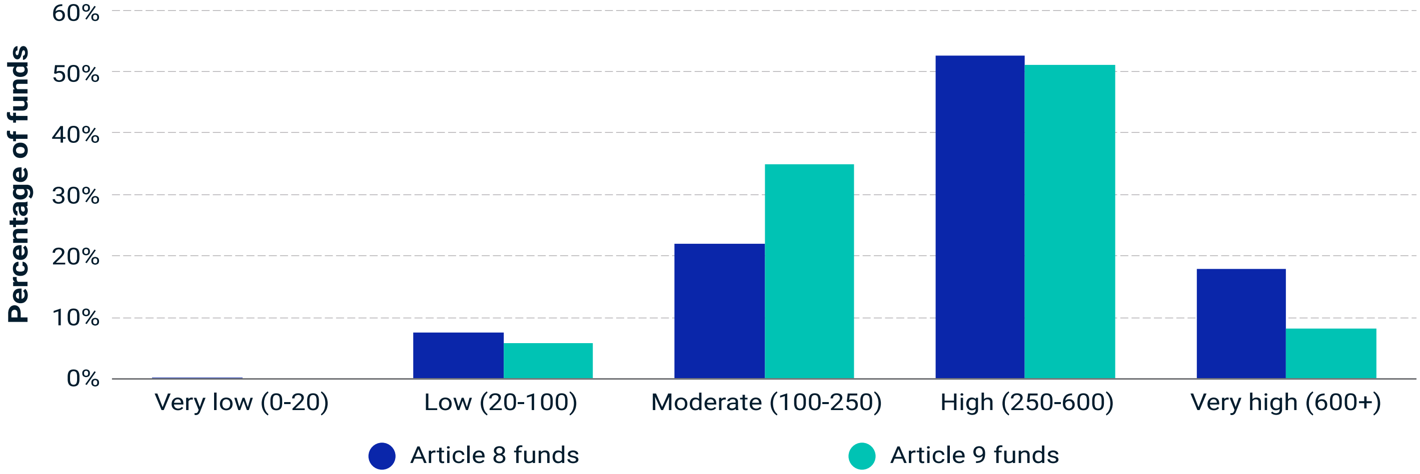
Article 9 funds performed well on carbon-footprint metrics, with 40% of funds having very low to moderate carbon footprints. More than double the percentage of article 8 funds fell into the "very high" category compared to article 9. We did observe a general increase in carbon footprints across the article 8 and 9 universe versus last year, likely due to better data availability on Scope 2 and 3 emissions.

Exhibit 11: Funds' exposure to companies active in the fossil-fuel sector by holdings weight (PAI 4)



Data as of July 15, 2024. Article 8 (*n* = 10,810) and article 9 (*n* = 927). Source: MSCI ESG Research

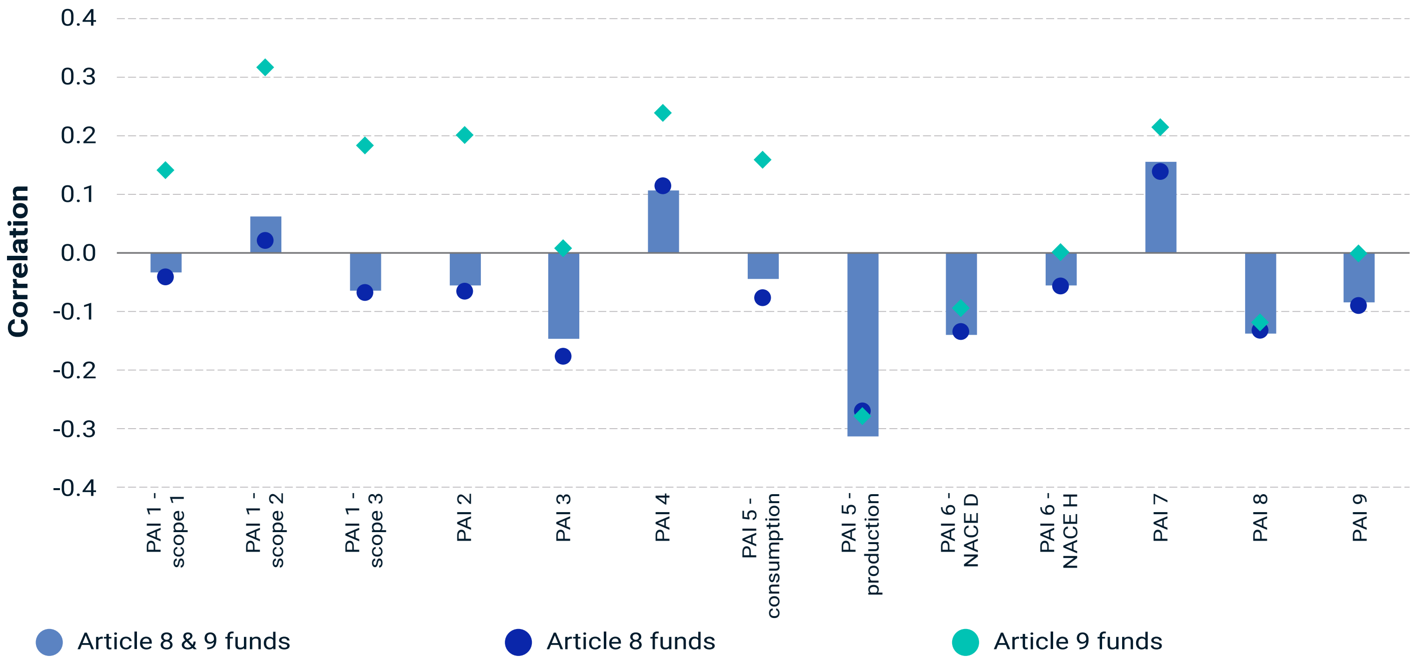
Exhibit 12: Funds' SFDR carbon footprint — Scopes 1, 2 and 3 (PAI 2)



Data as of July 15, 2024. Article 8 (*n* = 10,408) and article 9 (*n* = 888). Carbon footprint is measured by tons of carbon dioxide equivalent (t CO2e) / EUR million invested. Source: MSCI ESG Research

The ESAs have suggested using a taxonomy-based criteria for environmental PAIs.[13] We tested to what extent the nine environmental PAIs are inversely correlated with taxonomy alignment (i.e., do funds with lower adverse impact metrics tend to have a higher taxonomy alignment?). In short, the answer is mixed. While most PAIs have a negative correlation, the strength of the inverse relationship is weak in many cases. Based on this analysis, the PAI most reflective of taxonomy alignment is PAI 5 (share of non-renewable energy). The results underscore the difference between the two regulatory frameworks, as a company's taxonomy-aligned revenues and the negative environmental impacts of its operations are ultimately two separate issues.

Exhibit 13: Correlation of funds' SFDR PAIs and taxonomy-aligned revenues



Data as of July 30, 2024. Article 8 (*n* = 10,819) and article 9 (*n* = 928). For PAI 5, the share of nonrenewable energy by consumption and production is split out. For PAI 6, data for NACE codes D (energy) and H (transportation) were used to represent high-energy-intensity industries. Source: MSCI ESG Research

13 "Joint ESAs Opinion on the assessment of the Sustainable Finance Disclosure Regulation (SFDR)," ESAs, June 18, 2024.

MiFID II **sustainability preferences**

The number of funds submitting data in the EET on a voluntary basis has risen significantly over the past year, including MiFID II disclosures on sustainability preferences.[14] The number of unique funds reporting under version 1 of the EET has nearly tripled to almost 23,000 from approximately 8,000, with another 1,000 or so unique funds reporting under version 2 only.[15] In aggregate, this represents around 70% of the total number of funds estimated to be in the scope of the EET (approximately 35,000), and therefore a meaningful proportion from which we can draw insights.

Exhibit 14: EET funds coverage

	EET version 1		EET version 2	
	No. of share classes	No. of funds	No. of share classes	No. of funds
June 30, 2023	50,309	8.217	n/a	n/a
June 30, 2024	102,871	22,573	69,344	11,399

Data as of June 30, 2024. Source: MSCI ESG Research and EET disclosures

Under MiFID II, fund providers must align investment products with clients' sustainability preferences using three options: taxonomy alignment, SI (as defined by SFDR Article 2(17)) or PAIs. Using EET data, as of June 30, 2024, 80% of European-domiciled funds disclosed that they consider at least one SFDR PAI in their investment strategy, an increase from 50% in 2023. This rises to 94% for article 8 and 9 funds. Changes to PAIs (both in scope and definition) as part of the proposed revisions to the SFDR Regulatory Technical Standards (RTS), could therefore have far-reaching implications for EU-based funds' investment strategies and their alignment with clients' sustainability preferences.[16]

14 "Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021, amending Delegated Regulation (EU) 2017/565 regarding the integration of sustainability factors, risks and preferences into certain organizational requirements and operating conditions for investment firms." Official Journal of the European Union, August 2021. In force since Aug. 2, 2022.

15 The new EET, version 1.1.2, was released by FinDatEx in December 2023 and includes minor updates. Fund-management companies are gradually migrating to the new template, with the majority still reporting under v1.1.1.

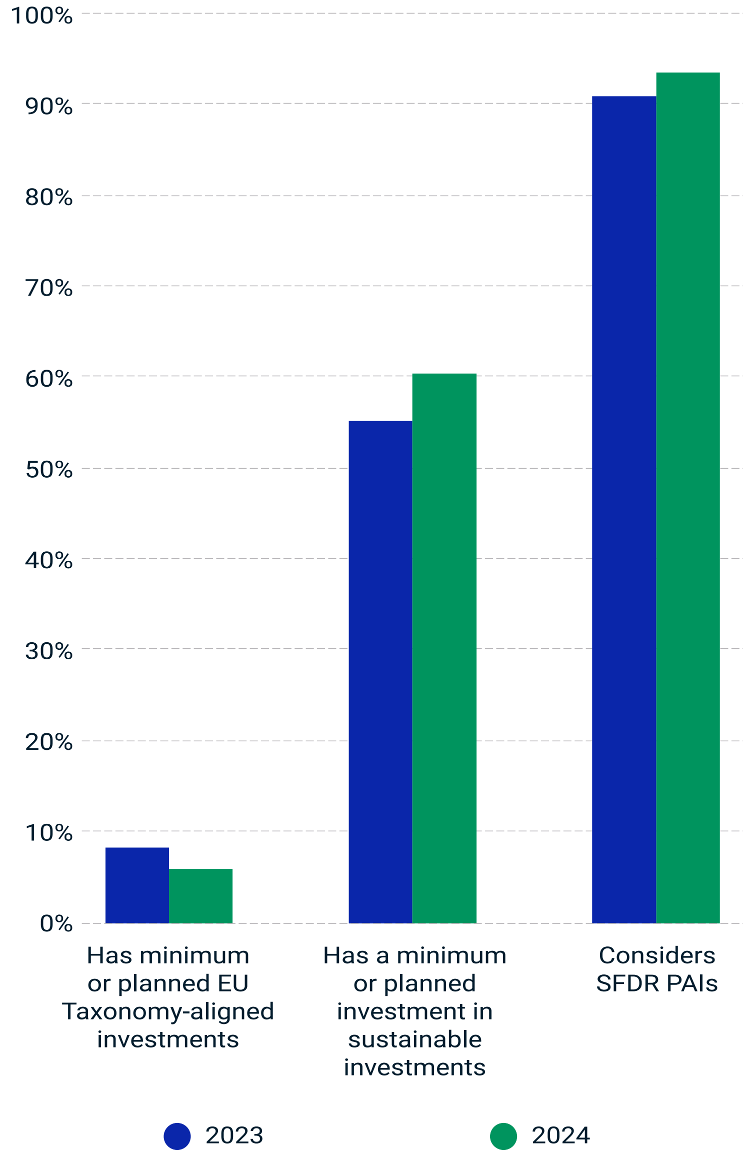
16 The proposed SFDR RTS — or level 2 legislation — are expected to be adopted by the European Commission by the end of 2024 and could come into force 12 months later. It may include changes to certain PAIs and a transparency requirement for how PAIs are being considered for SI.

Nearly half of European-domiciled funds had a "minimum or planned investment in sustainable investments" as defined under SFDR Article 2(17), closing the gap with article 8 and 9 funds (60%). The European Commission's broad interpretation of SI[17] currently makes this more achievable, but there are growing calls for a consistent definition of SI (see "ESAs and ESMA proposals" in the appendix). The percentage of article 8 and 9 funds stating minimum EU Taxonomy-aligned investments remains low (less than 10%) and declined versus last year, in contrast to an increase in minimum SI and PAI considerations (Exhibit 15).

EET disclosures show that exposure-based adverse-impact metrics remain the most widely considered PAIs compared to quantitative indicators, as of June 30, 2024. For example, 97% of article 9 funds considered exposures to controversial weapons (PAI 14), but only 77% considered energy consumption (PAI 6) – see Exhibit 16. Article 9 funds exhibited a stronger commitment to PAIs than article 8 funds, as one might expect. Compared to last year, we also observed an increase in PAIs being considered by article 9 funds, suggesting growing recognition of the regulatory guidance, which requires article 9 funds to consider all mandatory PAIs to meet "do no significant harm" obligations. In practice, this was applied more selectively in the past.

17 "Answers to questions on the interpretation of Regulation (EU) 2019/2088, submitted by the European Supervisory Authorities on 9 September 2022," European Commission, May 20, 2023.

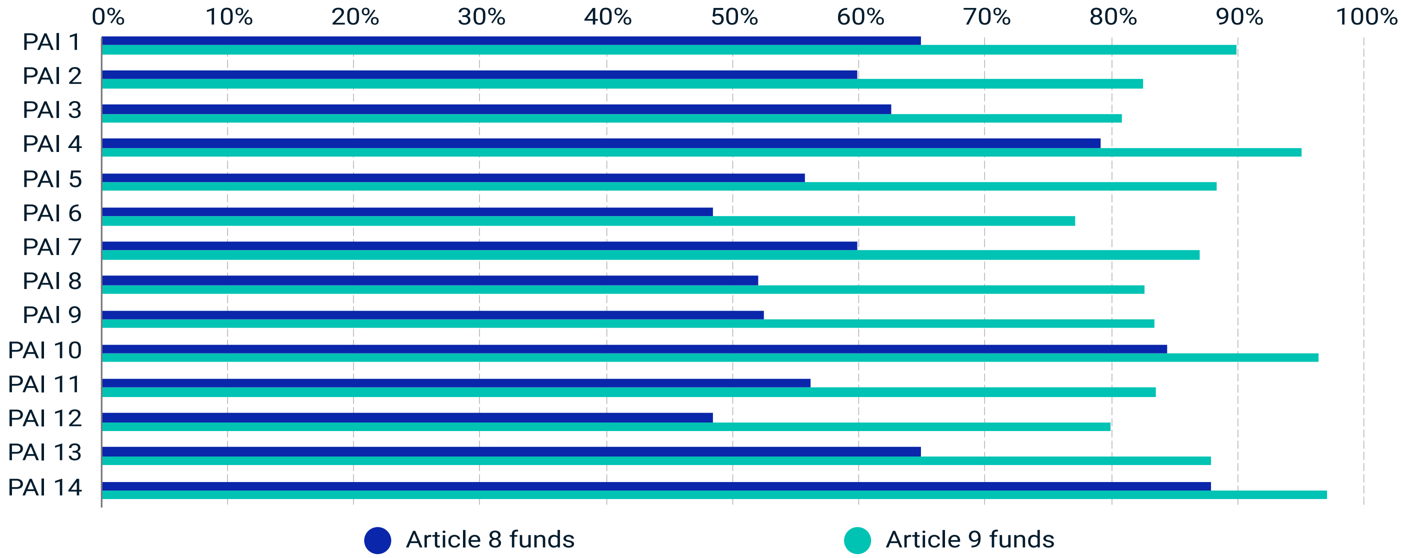
Exhibit 15: Percentage of article 8 and 9 funds considering MiFID II categories of sustainability preferences



Data as of June 30, 2023 (*n* = 4,203) and June 30, 2024 (*n* = 13,742). Source: MSCI ESG Research and EET disclosures

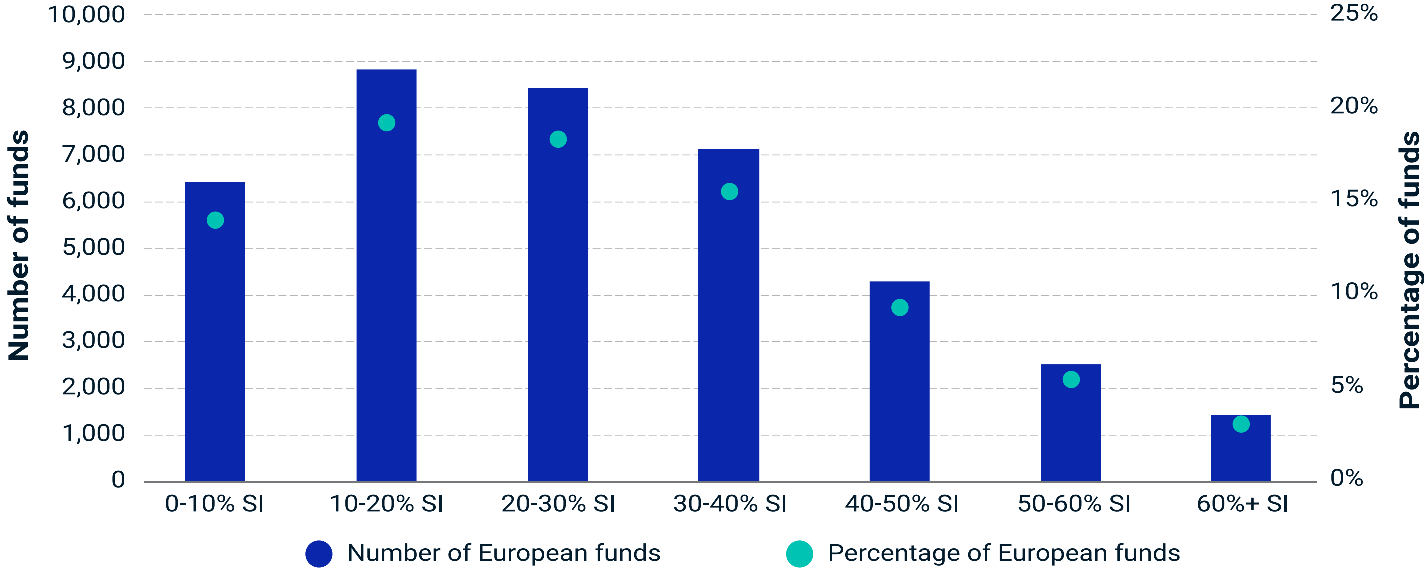
The third element of MiFID II sustainability preferences is SI. We assessed SI levels in European funds using MSCI's criteria for SI, under SFDR Article 2(17), to ensure a consistent basis of comparison (though this might differ from EET-reported figures based on the funds' own interpretation)– see Exhibit 17.[18] Our analysis revealed most funds had 10-20% of their portfolio passing as SI, representing a fifth of the European funds' universe. In aggregate, only half of European-domiciled funds have at least 20% of their portfolio in SI. This rises to 65% and 87% for article 8 and 9 funds, respectively. Overall, only 3% of European funds have an SI allocation above 60%, largely being article 9 funds. On average, article 8 and 9 funds have an SI allocation of 29% and 45%, respectively, based on MSCI's assessment.

Exhibit 16: Percentage of article 8 and 9 funds considering individual PAIs



Data as of June 30, 2024. Article 8 (*n* = 12,659) and article 9 (*n* = 1,083). Source: MSCI ESG Research and EET disclosures

Exhibit 17: European funds with holdings meeting MSCI's criteria for SI



Data as of June 30, 2024 (*n* = 39,083). Source: MSCI ESG Research

18 MSCI's interpretation of the three building blocks for SI: good governance practices, DNSH and positive contribution to an environmental or social objective. For more information, refer to "MSCI SFDR Article 2(17) Sustainable Investment Methodology," MSCI ESG Research, June 2023.

To rename or **not to rename**

ESMA's fund-naming rules and the FCA's SDR share the goals of enhancing transparency, preventing greenwashing and ensuring consistency in how funds are promoted to retail investors. Central to both frameworks is ensuring fund names reflect the sustainability profile of underlying investments, though ESMA's approach is more prescriptive. ESMA's threshold for investing at least 80% of a fund's assets in line with the fund's objective is also higher than that of the SDR (70%).

ESMA fund-naming rules

In May 2024, ESMA published its guidance on fund names using ESG- or sustainability-related terms. In response to this, MSCI has developed PAB- and CTB-aligned exclusion screens specifically for the ESMA use case, to help determine whether funds align with the prescriptive guidelines outlined in Exhibit 18. These screens allow fund managers and selectors to assess a fund's exposure to issuers that are flagged for exclusion from the PAB and CTB screens.

Exhibit 18: Summary of ESMA's fund-naming guidance

1 Transition-, Social- and Governance-related terms	2 Environmental- or Impact-related terms	3 Sustainability-related terms
80% threshold linked to the proportion of investments that meet E/S characteristic or SI objectives in accordance with the binding elements of the investment strategy		
Exclude investments based on CTB criteria* Article 12(1)(a) to (c) of CDR (EU) 2020/1818	Exclude investments based on PAB criteria* Article 12(1)(a) to (g) of CDR (EU) 2020/1818	
Funds using 'transition-' or 'impact' related terms should also ensure that investments are on a **clear and measurable path to E/S transition** or made with the **objective to generate a positive and measurable E/S impact** alongside a financial return.		Meaningfully invest in SI (Art. 2(17) SFDR)

Source: MSCI ESG Research

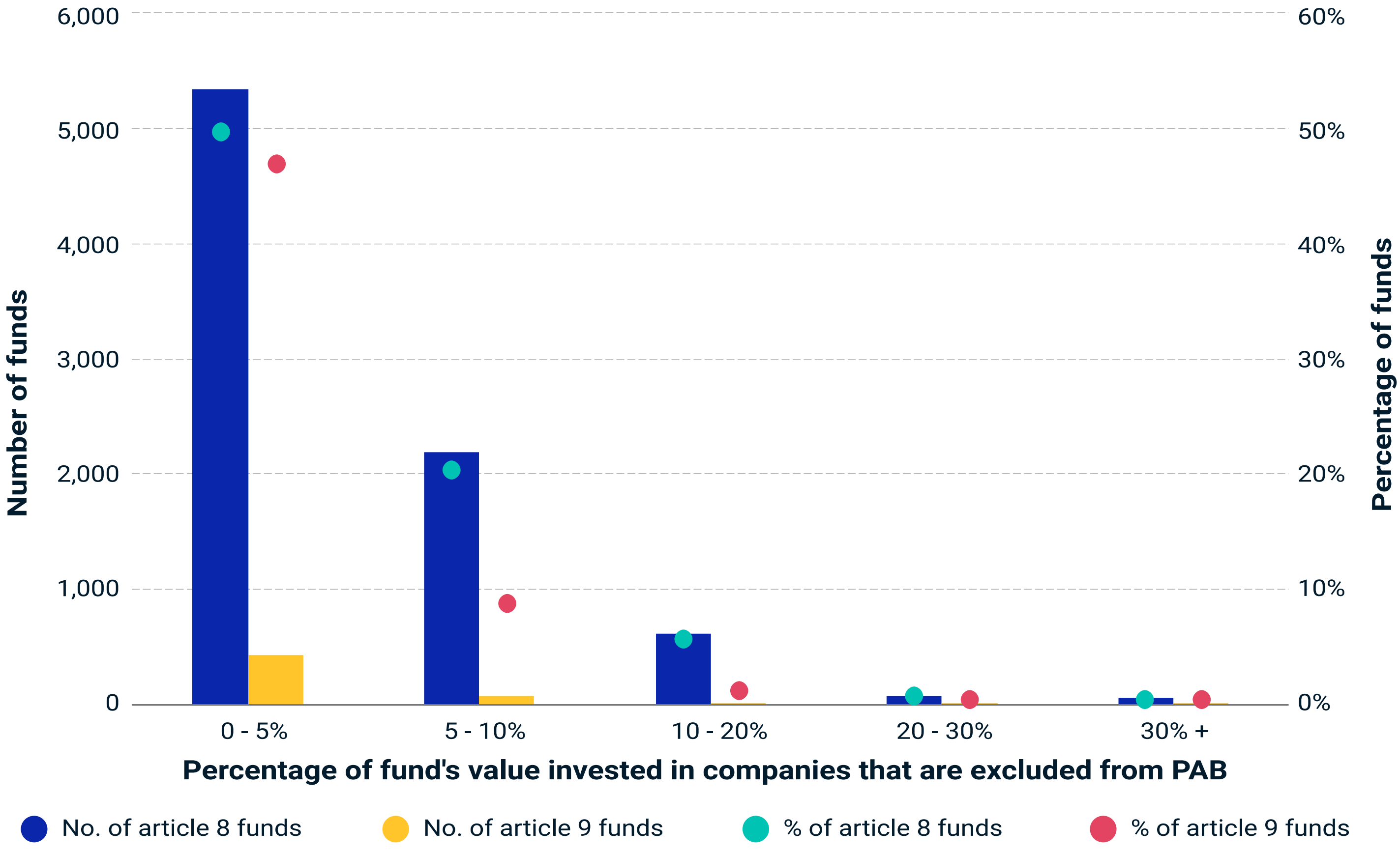
19 EU Paris Aligned Benchmarks (PAB) (as per Article 12(1)(a) to (g) of CDR (EU) 2020/1818 (PAB)) and EU Climate Transition Benchmarks (CTB) (as per Article 12(1)(a) to (c) of CDR (EU) 2020/1818 (CTB)).

20 As of Aug. 31, 2024, MSCI has adopted a more conservative approach of flagging companies with combined revenues from oil and gas at the lower (10%) threshold due to current data limitations in consistently separating oil from gas revenue in exploration, distribution or refining. Central to ESMA's guidance is addressing greenwashing concerns. We believe a more conservative approach is therefore currently prudent. Additional factors splitting out oil and gas revenues are due to be available in Q4 2024.

At the end of July 2024, our analysis found 30 fewer funds using sustainability-related terms in their names compared to May, when ESMA issued its guidance, while the number of funds using the term “transition” increased by 16. We believe this trend is likely to continue given stricter PAB exclusions for funds using sustainability-related terms.

For article 8 and 9 funds within MSCI’s coverage, close to 50% of those not aligned with PABs have only a small allocation (0-5%) to companies that would need to be excluded under a PAB screen. This suggests alignment could be manageable for many funds that are subject to ESMA’s rules.

Exhibit 19: Article 8 and 9 funds not aligned with PABs

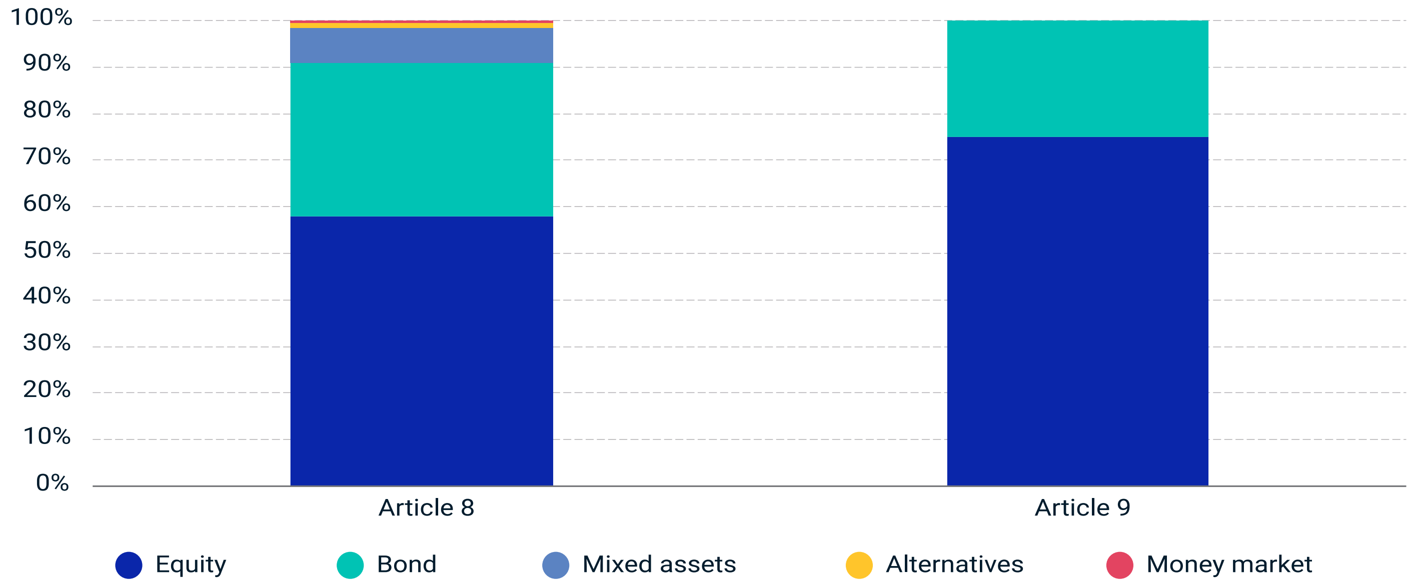


Data as of July 31, 2024. Article 8 (*n* = 8,294 and article 9 (*n* = 535). Source: MSCI ESG Research

Our analysis found that green-bond and infrastructure funds are particularly impacted by ESMA’s fund-naming rules. Bond strategies account for a quarter of article 9 funds with the highest fossil-fuel exposures (PAB screen >10%), with the Xtrackers Corporate Green Bond ETF the highest among them (22% PAB exposure). Despite the EU Green Bond Standard allowing issuers from the utility and energy sectors, bond funds using “green” in their name must apply PAB fossil-fuel exclusions under ESMA’s rules. The International Capital Market Association (ICMA) has therefore called for green- and sustainable-bond funds to be exempt from PAB exclusions, an issue that remains unresolved at the time of writing.[21]

21 “ICMA feedback on the application of Paris-aligned Benchmarks (PAB) exclusions to sustainable bond investments under the recent ESMA Guidelines,” ICMA, June 20, 2024.

Exhibit 20: Article 8 and 9 funds with the highest PAB exposures by asset class



Data as of July 31, 2024. Funds with PAB exposures >10%. Article 8 (*n* = 753) and article 9 (*n* = 20). Source: MSCI ESG Research

Equity infrastructure funds face a similar challenge — either changing names or divesting holdings. The divestment impact could be significant, given up to 50% of portfolio holdings fail the PAB screen (Exhibit 21), and would reflect a substantial change in investment strategy.

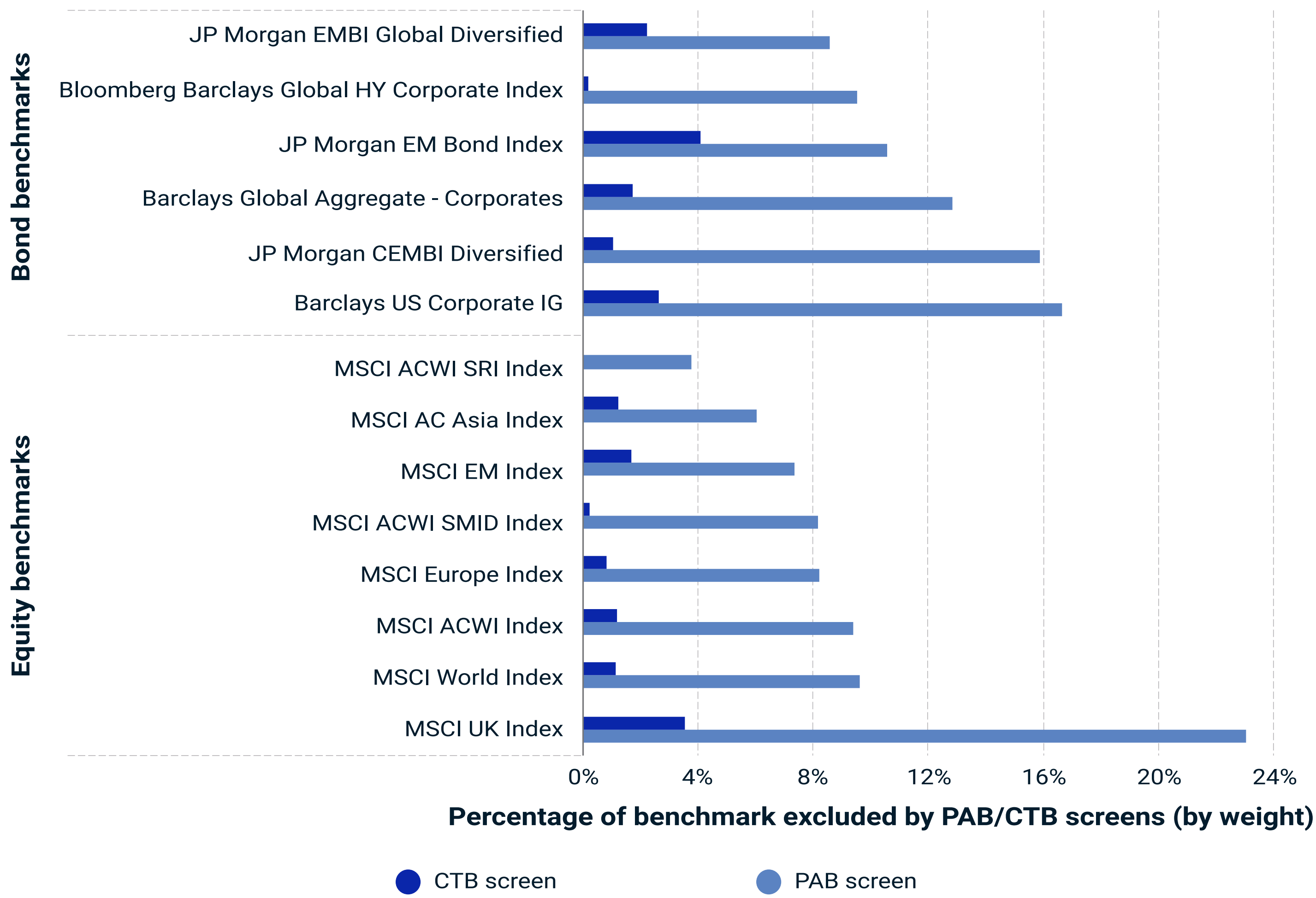
Exhibit 21: PABs put article 9 infrastructure funds under the spotlight

Fund name	Asset class	Fund type	Restricted term	ESMA naming category	PAB exclusion screen (%)	SI (%)
PGIF Global Sustainable Listed Infrastructure Fund	Equity	Mutual fund	Sustainable	Sustainability	47.6%	28.7%
Macquarie Sustainable Global Listed Infrastructure	Equity	Mutual fund	Sustainable	Sustainability	40.4%	38.9%
Nuveen Global Clean Infrastructure Impact Fund	Equity	Mutual fund	Clean	Environmental	33.8%	47.9%
Schroder ISF Sustainable Infrastructure	Equity	Mutual fund	Sustainable	Sustainability	24.6%	55.4%
EcoFin Global Renewables Infrastructure	Equity	Mutual fund	Renewables	Environmental	23.6%	56.3%

Data as of July 31, 2024. Table includes infrastructure funds with the largest fossil-fuel exposures, based on PABs. SI are based on MSCI's assessment. Source: MSCI ESG Research

ESMA's fund-naming rules may also impact how fund managers construct portfolios. In the issuer investable universe, PAB exclusions are generally higher in major bond indexes than in equities (e.g., U.S. investment-grade exclusions were double those of the MSCI ACWI Index as of July 2024). Over 90% (by weight) of major equity benchmarks, such as the MSCI ACWI Index, pass the PAB screen, offering more choice for equity-fund managers than bond-fund managers. Geographically, Asian and emerging market (EM) equity indexes have lower PAB exposures than for Europe, with nearly a quarter of the MSCI UK Index failing the PAB screen. These factors may influence fund managers defining sustainability-fund mandates and selecting eligible investments. For example, it may result in more allocations toward developing markets or away from U.K. equities. Limiting the investable universe could also result in greater portfolio concentration and holdings overlap between sustainability-related funds, impacting fund selectors in building diversified portfolios. CTB exclusions, which are less restrictive, are negligible for both asset classes.

Exhibit 22: Smaller universe of eligible investments for bonds than equities



Data as of July 31, 2024. The PAB screen applied is for the ESMA use case. Source: MSCI ESG Research

The UK take — Sustainability Disclosure Requirements

The phasing in of the U.K.'s SDR began on May 31, 2024, with the FCA's anti-greenwashing rule, which set stricter disclosure requirements. Since July 31, 2024, U.K. asset managers can choose one of four fund labels to promote their products: sustainability focus, sustainability improvers, sustainability impact or sustainability mixed goals. To qualify for a label, funds need at least 70% of their assets to meet a label's objectives.

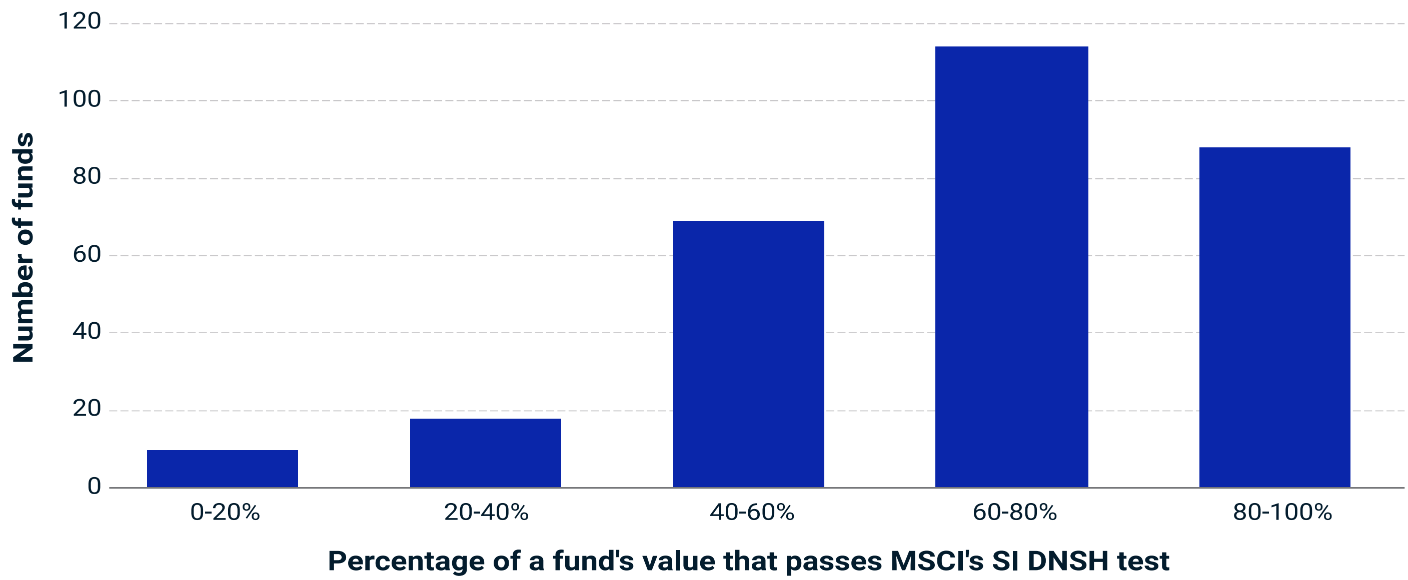
Asset managers have, however, struggled with the principles-based approach of the fund-labeling regime and sought clearer guidance from the FCA.[22] In most cases, after the FCA extended its deadline, U.K.-domiciled funds using restricted terms now have until April 2025 to amend fund names if a label is not adopted. According to the U.K.'s fund trade body, the Investment Association, uptake is expected to be mixed, with nearly a third of firms indicating they are unlikely to adopt a label within the next two years.[23]

We estimate 320 funds (including 19 investment trusts) domiciled/listed in the U.K. are using in-scope sustainability-related terms, with AUM totaling GBP 175 billion (compared with the article 8 and 9 fund universe of over EUR 7 trillion). Collectively these represent around 20% of the total sustainability-related funds available for sale in the U.K., with the remainder mostly domiciled in Ireland and Luxembourg (and therefore subject to ESMA's rules). As of Sept. 30, 2024, only four funds had publicly disclosed their adoption of a label — in three cases, the choice was sustainable impact.

In the absence of prescribed metrics in the regulation, MSCI undertook a mapping exercise to help fund managers assess which metrics could support the adoption of SDR labels; for example, EU Taxonomy-Aligned Revenue to demonstrate environmentally SI, or negative screens, such as the EU Sustainable Investment "do no significant harm" (DNSH) test to assess adverse environmental or social impacts. Our analysis showed two-thirds of SDR-eligible funds had at least 60% of their investments passing the DNSH test (based on MSCI's definition).[24] Given the regulation does not specify a threshold, we set 60% as a potential minimum standard. The 10% of funds with a pass rate below 40% may find it easier to change their fund name.

Using MSCI's definition of SI under SFDR Article 2(17), only six funds had a minimum SI allocation of 70%, representing only 2% of in-scope SDR funds according to our analysis. All six are equity mutual funds, although they have no common investment focus. The estimated percentage of EU Taxonomy-aligned revenues ranges from 3% to 58%, highlighting the current lack of comparability across frameworks.

Exhibit 23: SDR funds that pass MSCI's EU SI DNSH test



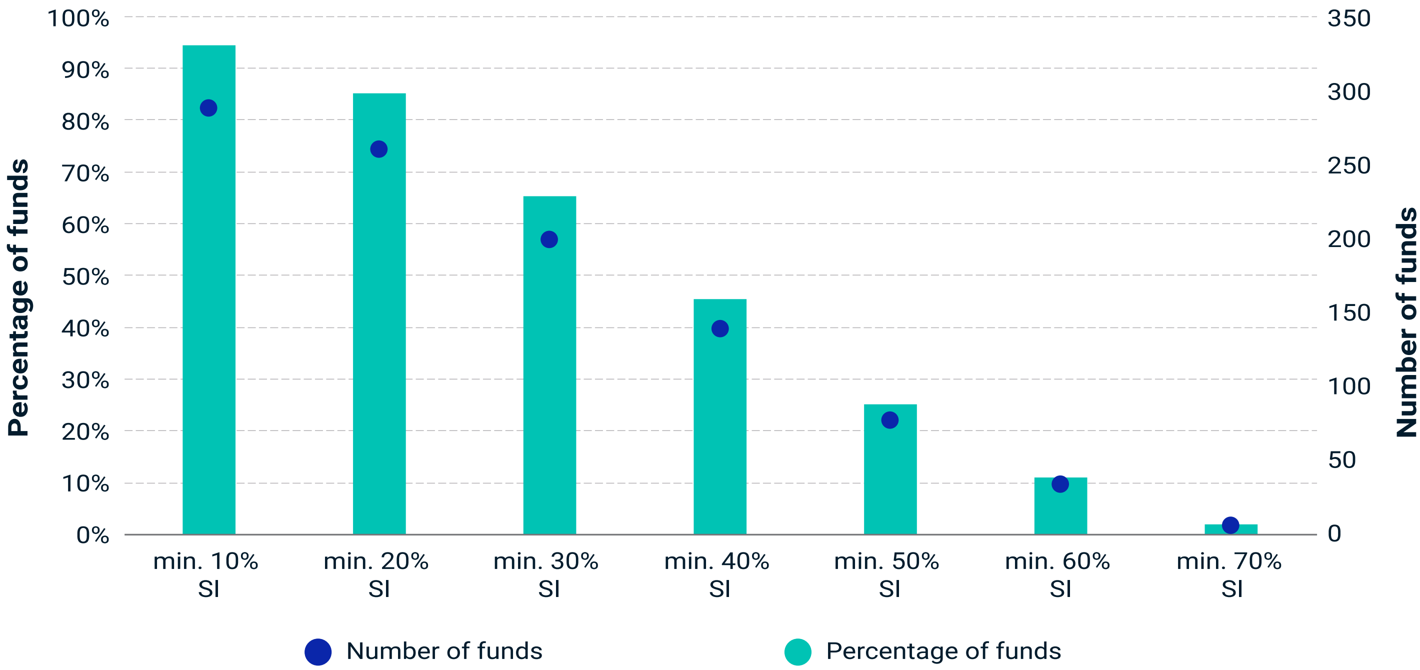
Data as of July 31, 2024, *n* = 305. Source: MSCI ESG Research

22 Dominic Webb, "Asset managers raise concerns over 'infuriating' SDR approvals process," Responsible Investor, July 2, 2024.

23 Dominic Webb, "Majority of managers to apply UK's SDR labels this year, survey finds," Responsible Investor, May 3, 2024.

24 MSCI's SI DNSH test uses the SFDR PAI indicators as the criteria for avoiding harm and meeting minimal social safeguards. MSCI ESG Research excludes companies with an orange or red controversy, those involved in controversial weapons and tobacco production, and those using thermal coal.

Exhibit 24: Room for improvement on SI for SDR-eligible funds



Data as of July 31, 2024, *n* = 305. Source: MSCI ESG Research

Exhibit 25: UK-domiciled funds in scope of SDR with at least 70% of AUM in sustainable investments

Fund name	Asset class	Investment focus	SI (%)	Estimated % of EU Taxonomy-aligned revenues	MSCI Fund ESG Rating
Schroder Global Energy Transition	Equity	Energy	85.6%	58.4%	AA
Virgin Money Climate Change	Equity	Europe large cap	75.8%	19.1%	AA
L&G Future World Sustainable UK Equity Focus	Equity	U.K. large cap	75.2%	3.0%	AA
TM Natixis Mirova Global Sustainable Equity	Equity	Global large cap	72.0%	13.3%	AA
JPM Climate Change Solutions	Equity	Global large cap	71.7%	21.8%	AA
FP Foresight Sustainable Future Themes	Equity	Global mid/small cap	70.5%	29.9%	AA

Data as of July 31, 2024. Source: MSCI ESG Research

Conclusion

Looking ahead, the European Commission's full review of the SFDR is ongoing and may take between two and three years before implementation can begin. The Commission will likely consider proposals put forward to enhance the SFDR's effectiveness and address current challenges in the European sustainable-finance framework, including the desire for greater simplicity. The impact of fund naming rules is also likely to be felt over the coming year, as fund names or investment strategies are adjusted. Meanwhile, as EU Taxonomy disclosures improve and are extended to more companies under CSRD, we anticipate fund managers and selectors will be better equipped to make informed decisions on sustainability-led portfolio construction and fund selection, all while keeping investor preferences in mind.

Appendix

ESA and ESMA proposals

In June 2024, the ESAs issued nonbinding recommendations to the European Commission for their forthcoming SFDR review to address current challenges and enhance clarity for retail investors. ESMA followed with an opinion paper in July 2024 that was broadly in agreement. The ESAs' proposals included:

1. Formally turning SFDR into a product-labeling regime. Replacing articles 8 and 9 with a new product-classification system with clear and objective criteria, including at least two labels:

    a) Sustainability
    - Products/activities that are environmentally and/or socially sustainable.
    - Minimum "sustainability threshold."
    - If not taxonomy-aligned, should pass DNSH and governance criteria.

    b) Transition
    - Not yet sustainable but improving sustainability over time.
    - Strategy could mix taxonomy KPIs, transition plans, mitigation of PAIs and some exclusion screens.
    - ESMA went further to say a definition of transition investments should be included in the regulations to help support the creation of transition funds.

2. Developing a sustainability indicator for financial products, such as a "Nutri-Score," to help guide retail investors. There has since been pushback on the merits of such a system and ESMA highlighted the significant methodological challenges in the medium term at least.

3. Reviewing the definition of SI to make it consistent and clearer. Clarifying the relationship between investments in taxonomy-aligned activities and SI. ESMA stated the EU Taxonomy should become the only common reference point for assessing sustainability.

4. Expanding key adverse-impact indicators to all financial products (e.g., government bonds) and performing a cost-benefit analysis of such a requirement.

5. The creation of a social taxonomy. ESMA added that the EU Taxonomy (environmental criteria) should be completed and extended to Social Taxonomy.

The European Commission currently has no stated deadline to announce an updated SFDR.

Sources:
"Joint ESAs Opinion on the assessment of the Sustainable Finance Disclosure Regulation," ESAs, June 18, 2024.
"ESMA sets out its long-term vision on the functioning of the Sustainable Finance Framework," ESMA, July 24, 2024.

Anti-greenwashing

Recent regulatory proposals and opinions have sought to address greenwashing risks. Some of these are summarized in the table, along with commonality across regulatory bodies.

The need for (i) clearer definitions of SI and transition and (ii) a more prescriptive product-labeling regime was also shared by the Sustainable Finance Advisory Board to the German government and France's L'Institut de la Finance Durable (IFD). In the U.K., the FCA's anti-greenwashing rule came into force on May 31, 2024, to ensure that sustainability-related claims are consistent with the sustainability profile of the product or service. The guidance includes requirements for clear product labeling, accurate marketing and comprehensive disclosure of sustainability impacts.

		ESMA	ESAs	BaFin[25]
		Greater convergence required in EU to facilitate comparability	Unclear or ambiguous definitions may contribute to difficulties in detecting greenwashing	Greater clarity required
Taxonomy	**Environmental taxonomy**	Complete current framework and environmental SI based on EU Taxonomy	Environmental SI based on EU Taxonomy	Environmental SI based on EU Taxonomy
	Create social taxonomy	√	√	√
SFDR	**Phase out articles 8 and 9**	√	√	√
	New product categorization	√ (incl. sustainability and transition)	√ (incl. sustainability and transition)	√ (three labels: sustainability, transition and exclusions)
	Sustainability indicator	√	√	√
	SI definition	Phase out Interim – add prescriptive thresholds	Reform or remove Interim – add prescriptive thresholds	Reform Reference the EU Taxonomy and other frameworks if needed (e.g., UN Sustainable Development Goals)
	DNSH definition	Reform		
	PAIs		Expand to more products and clarity on mitigation	Cut number by two-thirds

Source: MSCI ESG Research

25 Rupert Schaefer, "There is a simpler and more effective way to do this," BaFin, July 17, 2024.

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