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Funds and the State of European Sustainable Finance

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Contents

Key takeaways:

- Most assets under management (AUM) in Europe (~EUR 7 trillion out of EUR 12 trillion) are invested in ESG funds or strategies with some sustainability-related focus. Most of the fund-based capital in Europe is therefore impacted to some degree by the EU Taxonomy for sustainable activities (EU Taxonomy), the Sustainable Finance Disclosure Regulation (SFDR) and the Markets in Financial Instruments Directive (MiFID II).
- We found that most article 8 and 9 funds stated no intent toward achieving EU Taxonomy alignment in their European ESG Template (EET) reporting — 88% of article 8 funds and 63% of article 9 funds did not include taxonomy-aligned investments. This is primarily driven by a shortfall in disclosures by underlying companies.
- Article 8 and 9 funds now collectively account for over EUR 6 trillion in assets (55% of AUM in Europe). As at the end of February 2023, EUR 5.9 trillion was invested in article 8 funds and EUR 323 billion in article 9 funds. There was more diversity in terms of asset class, geographic region and sectoral focus in article 8 funds — an important consideration for fund investors and those constructing portfolios from funds.
- For portfolio constructors seeking to create funds optimized for Principle Adverse Impact (PAI) indicators, disclosure levels are a key determinant. Assessing the large- and mid-cap investable universe revealed high dispersion on disclosure of environmental PAIs such as emissions-based metrics (Scopes 1-3). European companies led the way with over 90% of European-domiciled large- and mid-cap firms disclosing Scope 1+2 emissions.
- Based on data disclosed in the EET as of March 31, 2023, we found over half of the funds domiciled in Europe were considering (committing to reduce or mitigate) at least one SFDR PAI in their investment strategy. When narrowing down the universe for article 8 and 9 funds only, almost 90% of them disclosed that they consider SFDR PAIs in their investment strategy.
- For funds that do consider SFDR PAIs, we found that consideration of involvement-type adverse impact indicators was more likely than consideration of quantitative indicators, for which thresholds are not prescribed by SFDR regulation. Specifically, 80% of funds considered exposure to companies active in the fossil-fuel sector (PAI 4) and 93% considered exposure to controversial weapons (PAI 14).

Introduction

The state of European sustainable finance has evolved rapidly in recent years. In 2018, the European Commission released an action plan for financing sustainable growth with the aims of reorienting capital flows toward sustainable investment, managing financial risks stemming from climate change and fostering greater transparency in economic activities to achieve sustainable and inclusive growth. Of relevance to funds, the action plan is underpinned by several legislative reforms, many of which fund managers are now contending with.

The EU Taxonomy[1] came into effect in 2020 and established criteria for classifying sustainable activities, allowing fund managers to evaluate the extent to which the economic activities of the companies they invested in were environmentally sustainable. SFDR, which took effect in 2021, endeavors to bring greater transparency to investors on sustainability factors and how sustainability risks are integrated in fund managers' investment processes. More recently, requirements to integrate sustainability considerations in investment products through amendments to MiFID II have been implemented. Collectively these regulations have had an impact on the European fund market, ranging from product launches and fund flows, through to the levels of transparency they provide to end investors.

This paper explores how the universe of funds domiciled in Europe performed across these different streams. In particular, we focus on article 8 and 9 funds — those classified by fund managers as promoting environmental and social characteristics or having sustainable investments as their objectives, as defined by SFDR regulation.[2] We assess the degree of EU Taxonomy-alignment for European-domiciled funds, their performance on, and disclosure of, select adverse sustainability impact indicators, and exposure to sustainable investments.

1 "EU Taxonomy for Sustainable Activities." European Commission.

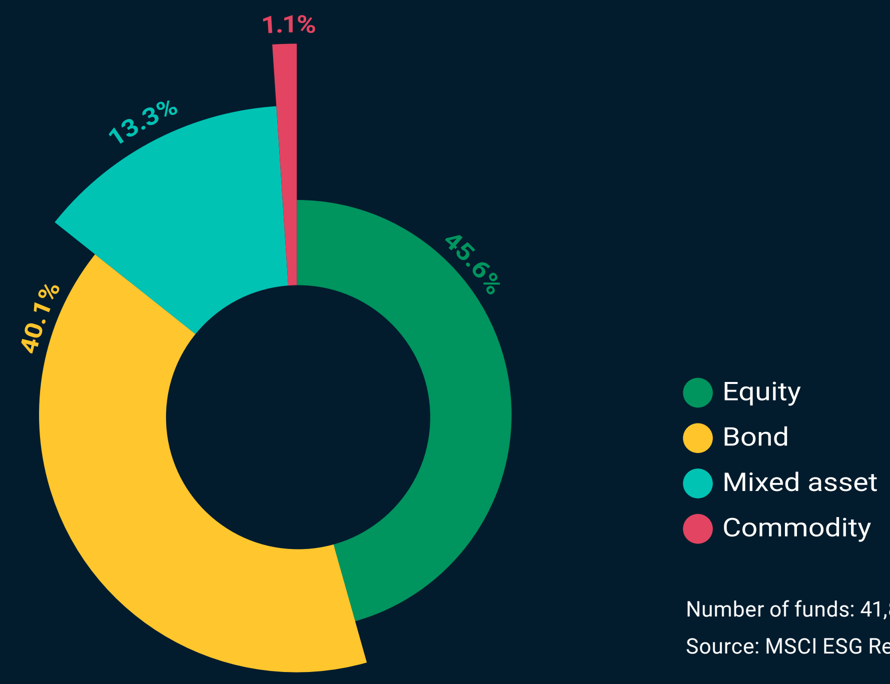
2 SFDR requires financial products to be categorized based on their level of sustainability, and mandates certain sustainability-related disclosures are made for investors. Funds are required to be classified into one of three categories, article 6, 8 or 9, depending on the product's sustainability objective. "Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector." EUR-Lex.

The European **fund market**

The European fund market is the world's second largest after the U.S., with almost EUR 12 trillion in AUM across nearly 30,000 unique funds. As of the end of April 2023, active funds accounted for almost 90% of funds domiciled in Europe and held over two-thirds of the region's AUM, with the balance being managed by index-based funds, including ETFs. We estimated that the majority of Europe's AUM (~EUR 7 trillion) was invested in ESG funds or strategies with some sustainability-related focus.[3] Most fund-based capital in Europe is therefore impacted to some degree by the EU Taxonomy, SFDR and MiFID II.

3 ESG funds are defined as funds that employ any ESG or sustainability-related considerations in its security-selection process, (e.g., values and screening/ranking/exclusions/integration/optimization, etc.). In simplest terms, it is the widest possible net under which any funds employing any sustainability considerations in security-selection are captured, based on the strategy prospectus and regulatory filings including claims of focus on sustainability, impact or ESG factors. All fund characterizations based on data from Broadridge and MSCI ESG Research, as of March 20, 2023.

Exhibit 1: Breakdown of European funds' EUR 12 trillion of AUM by asset class



Number of funds: 41,804. Data as of April 30, 2023.

Source: MSCI ESG Research

EU Taxonomy

The EU Taxonomy is relevant for fund investments as it provides a standardized framework for determining whether an investee company's economic activity is environmentally sustainable. By using it, fund managers may be better able to identify and assess investments that are aligned with the EU's sustainability objectives and communicate their environmental impact to investors. This, in turn, can help investors make more-informed decisions about where to allocate their capital if their investment objectives are, in part or in whole, to promote the transition to a more sustainable economy.

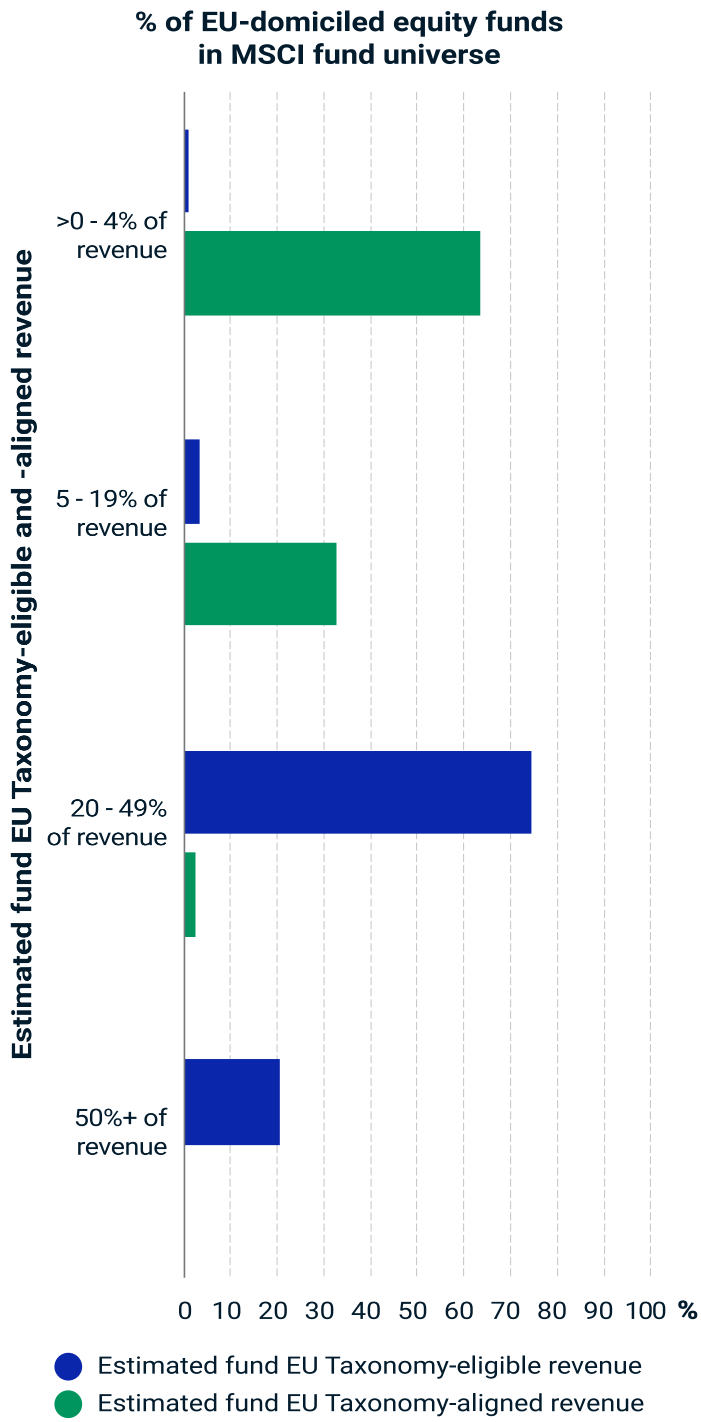
The framework centers around financial-market participants reporting the percentage of environmentally sustainable investments using consistent and comparable definitions.[4] The EU Taxonomy, however, is only partially developed (currently only focused on mitigation and adaptation) and European corporations have only just started disclosing their alignment to it this year.

Based on data disclosed by funds in the EET[5] as of April 30, 2023, we found a limited number of article 8 and 9 funds disclosing EU Taxonomy-alignment. Of the 13,419 European funds analyzed, of which 6,603 were article 8 or 9 funds, only 126 reported a figure for EU Taxonomy-aligned revenue. Of these, the majority (114 funds) reported zero aligned revenue. The picture was even more bleak for reported capital and operational expenditure aligned with the EU Taxonomy.

4 EU Taxonomy-aligned activities are defined as those that demonstrate that they contribute substantially to one environmental objective, do not significantly harm any of the other environmental areas and meet minimum social safeguards with respect to international norms, such as the OECD Guidelines and UN Guiding Principles on Business and Human Rights. As of Feb. 1, 2023, the technical criteria are only defined for climate-change mitigation, with adaption to the four remaining objectives (relating to pollution, water resources, biodiversity and the circular economy) expected to take place over the course of 2023.

5 The EET is the official template for ESG data disclosures by funds to support the Regulatory Technical Standards (RTS) for SFDR.

Exhibit 2: Equity funds with EU Taxonomy-eligible and -aligned activities



EU Taxonomy-eligible revenue is revenue generated from an activity included in the EU Taxonomy as having the potential to be sustainable. EU Taxonomy-aligned revenue is revenue generated from an activity that is EU Taxonomy-eligible and meets all the technical screening criteria set in the regulation to be identified as sustainable. Number of funds: 11,691. Data as of April 30, 2023. Source: MSCI ESG Research

In the absence of substantial amounts of reported data, we looked at estimated EU Taxonomy-aligned revenue to evaluate the portion of funds in MSCI's coverage universe that were aligned to the EU Taxonomy. Across European-domiciled equity funds (11,691 funds), the majority (63%) had exposure to small amounts of EU Taxonomy-alignment, while the funds with at least 20% aligned revenue accounted for only 2% of the European funds' universe.

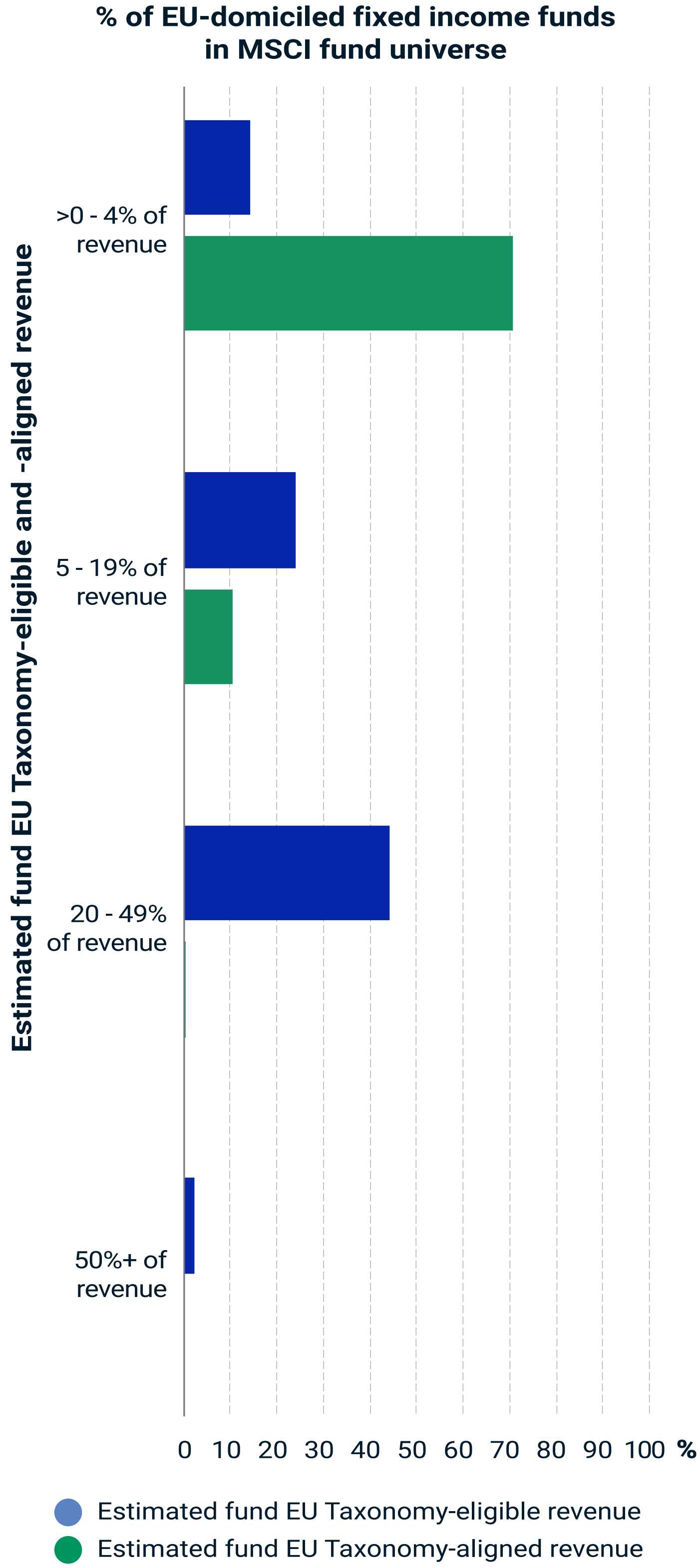
A similar picture was painted for European-domiciled fixed-income funds (6,296 funds). There were no funds identified with estimated alignment to the EU Taxonomy's sustainable activities of more than 20%, but over two-thirds of funds had some extent of involvement in aligned activities (i.e., aligned revenue greater than zero but less than 20%).

In the total universe of equity and fixed-income funds, only 12 were estimated to have aligned revenue over 60%. Of the 12 funds, 10 had an investment focus on clean technologies and renewable-energy exposure such as wind and solar, suggesting that prioritizing funds with high EU Taxonomy-aligned revenues may have come at the expense of sector diversification.

Under the EU Action Plan for Financing Sustainable Growth, SFDR is heavily linked to EU Taxonomy. The two regulations come together for fund-level reporting whereby, if a fund is classified as article 8 (has environmental or social attributes) or as article 9 (has a sustainable investment objective as defined by SFDR), then it is required to report a range of metrics, including the aggregated fund-level EU Taxonomy-alignment of underlying company investments. Yet there is a lack of company disclosure on EU Taxonomy-related revenue, so the question then becomes: How can funds accurately convey their sustainable nature leveraging the EU Taxonomy without the necessary bedrock of company disclosures? The short answer is that, right now, they cannot.

We found that the overwhelming majority of article 8 and 9 funds stated "no intent" vis-a-vis EU Taxonomy-alignment in their EET reporting — 88% of article 8 funds and 63% of article 9 funds did not include taxonomy-aligned investments. Notably, most highly aligned funds (nine out of 12) were classified as article 8 funds under SFDR, with only two being article 9, which may appear counterintuitive to impact-focused fund selectors.

Exhibit 3: Fixed-income funds with involvement in EU Taxonomy-eligible and -aligned activities



Number of funds: 6,296. Data as of April 30, 2023. Source: MSCI ESG Research

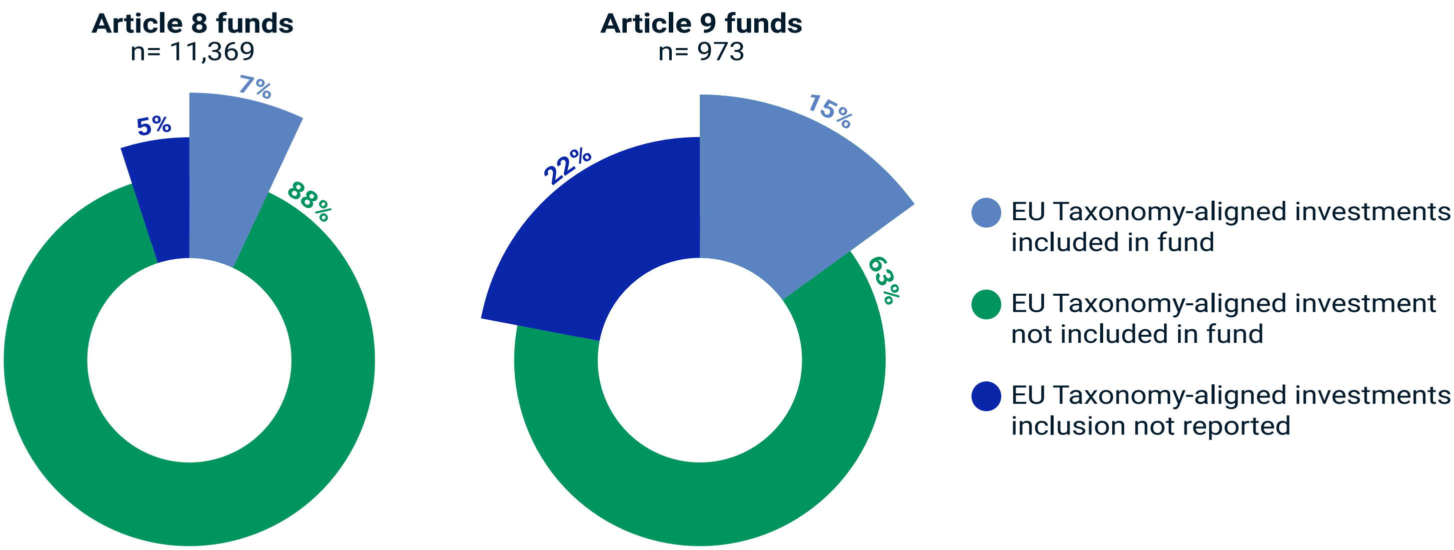
All of this may be attributed to the incomplete nature of the EU Taxonomy or to the level of stringency set for sustainable activities. Although reporting volumes have increased, company disclosure data for EU Taxonomy eligibility and alignment criteria remain low. Even in the future, the extent to which non-EU companies disclose information in line with taxonomy requirements remains to be seen. In either case, it leaves sustainability-minded fund selectors with a limited pool of options to invest in, which may be challenging for mandates that require a minimum level of EU Taxonomy-alignment while balancing diversification needs.

Exhibit 4: (Not) spoiled for choice — only 12 funds with >60% estimated EU Taxonomy-aligned revenue

Fund name	Fund type	Asset class	SFDR article	Estimated % of EU Taxonomy-aligned revenue
Global X Wind Energy UCITS ETF	ETF	Equity	8	83.3%
Assenagon Funds Green Economy Fund	Mutual fund	Equity	9	75.5%
Fidelity Clean Energy UCITS ETF Fund	ETF	Equity	8	72.4%
HANetf S&P Global Clean Energy Select HANzero UCITS ETF Fund	ETF	Equity	8	70.5%
Invesco Solar Energy UCITS ETF Fund	ETF	Equity	8	68.5%
Global X Cleantech UCITS ETF Fund	ETF	Equity	8	66.8%
Global X Solar UCITS ETF Fund	ETF	Equity	8	66.7%
Storebrand Renewable Energy	Mutual fund	Equity	9	64.2%
OCC 21	Mutual fund	Equity	-	63.6%
iShares Global Clean Energy UCITS ETF	ETF	Equity	8	60.9%
Global X Renewable Energy Producers UCITS ETF Fund	ETF	Equity	8	60.3%
Deka Future Energy ESG UCITS ETF	ETF	Equity	8	60.3%

The EU does not prescribe any specific threshold for funds to be classified as "EU Taxonomy-aligned." In this example, 60% was set as an arbitrary threshold that may be deemed as a minimum standard. Fund classification as of March 2023. Source: MSCI ESG Research

Exhibit 5: SFDR, funds and EU Taxonomy-alignment



The EU does not prescribe any specific threshold for funds to be classified as "EU Taxonomy-aligned". In this example 60% was set as an arbitrary threshold, that may be deemed as a minimum standard. Fund classification and EET disclosures as of April 30 2023. Source: MSCI ESG Research.

Sustainable Finance Disclosure Regulation

SFDR requires financial-market participants, including asset managers and pension funds, to disclose how they integrate sustainability risks and factors into their investment decision-making processes and how they consider the potential adverse impacts of their investments on sustainability factors. This information is aimed toward helping investors make better-informed decisions that align with their sustainability preferences and goals. Additionally, SFDR aims to increase transparency in the investment industry, to promote greater accountability and help address greenwashing concerns.

We collected data on over 12,000 SFDR-disclosing funds domiciled in Europe from a universe covering over 99.3% of funds being distributed to European-based investors. We present our findings below.

Article 8 and 9 funds

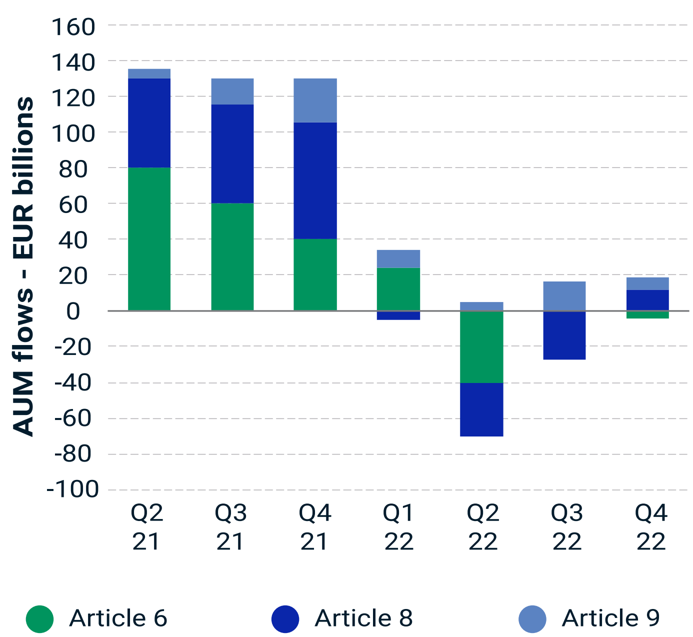
As at the end of February 2023, article 8 and 9 funds collectively accounted for over EUR 6 trillion in assets (55% of fund AUM in Europe). A total of EUR 5.9 trillion was invested in article 8 funds and EUR 323 billion in article 9 funds. There were 12 times as many article 8 funds compared to article 9 for investors to choose from, and these funds collectively held 18 times more assets. This imbalance may continue, as updates in regulatory guidance have driven reclassifications of funds. Our analysis indicated that approximately 20% of SFDR classifications for European funds changed over the previous year, with a net migration from articles 6 and 9 into article 8. As fund managers have grappled with the exercise of self-classification, over 1,000 funds recategorized their SFDR status in the second half of 2022, not counting their numerous share classes and currency listings.

Exhibit 6: Defining articles 6, 8 and 9 of SFDR

SFDR
Article 6 funds Funds without sustainability considerations in scope
Article 8 funds Funds that promote environmental or social characteristics alongside other factors
Article 9 funds Funds that have sustainable investment and positive external impact as core investment objectives

Source: MSCI ESG Research

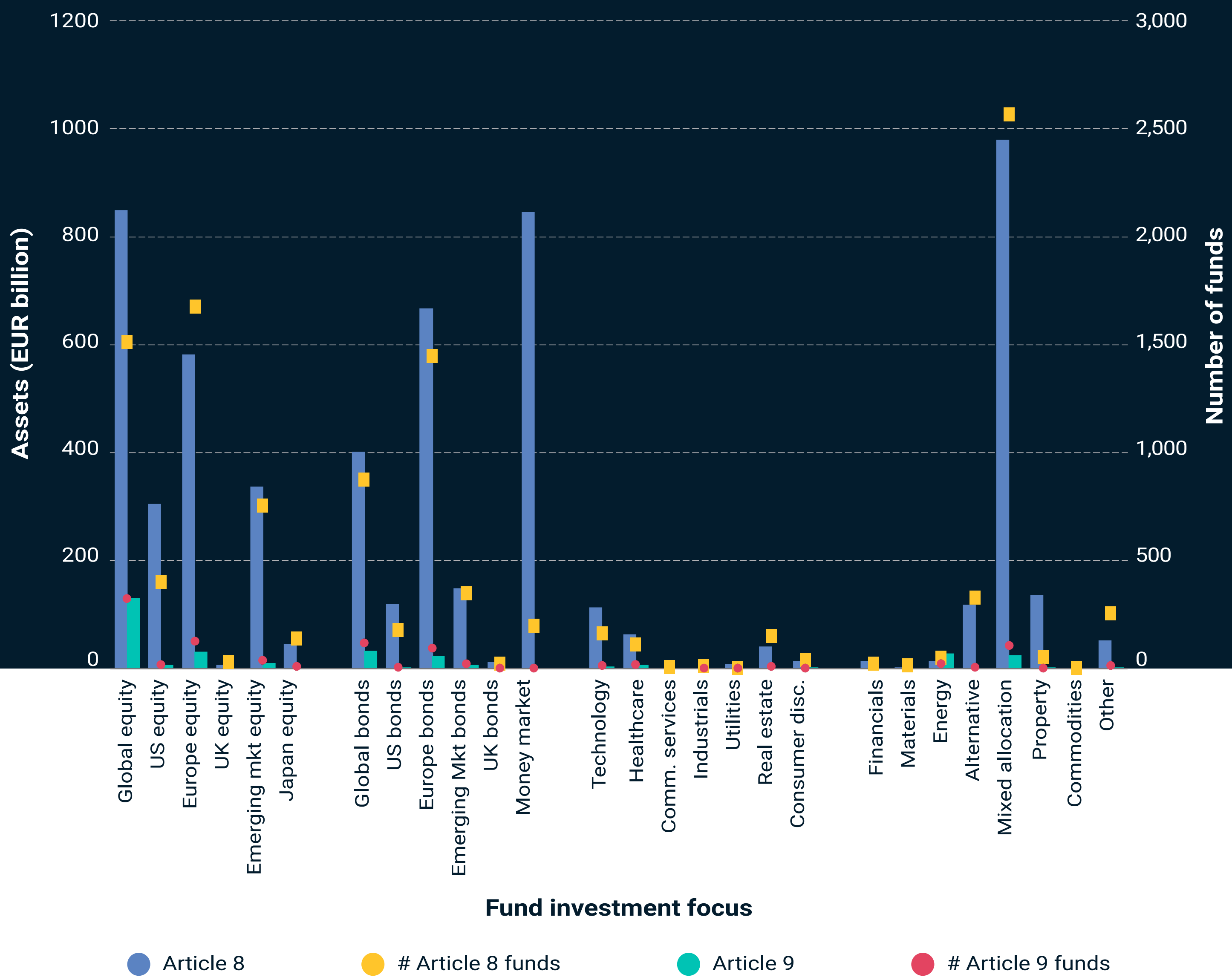
Exhibit 7: Categorizations in flux – AUM flows into/out of article 6, 8 and 9 funds



Data as of Dec. 31, 2022. Source: MSCI ESG Research

In terms of fund types, global equity strategies dominated across both article 8 and 9 funds, though there was more diversity of choice in asset class, geographic and sectoral focus for article 8 funds — an important consideration for fund investors and those constructing portfolios from funds.

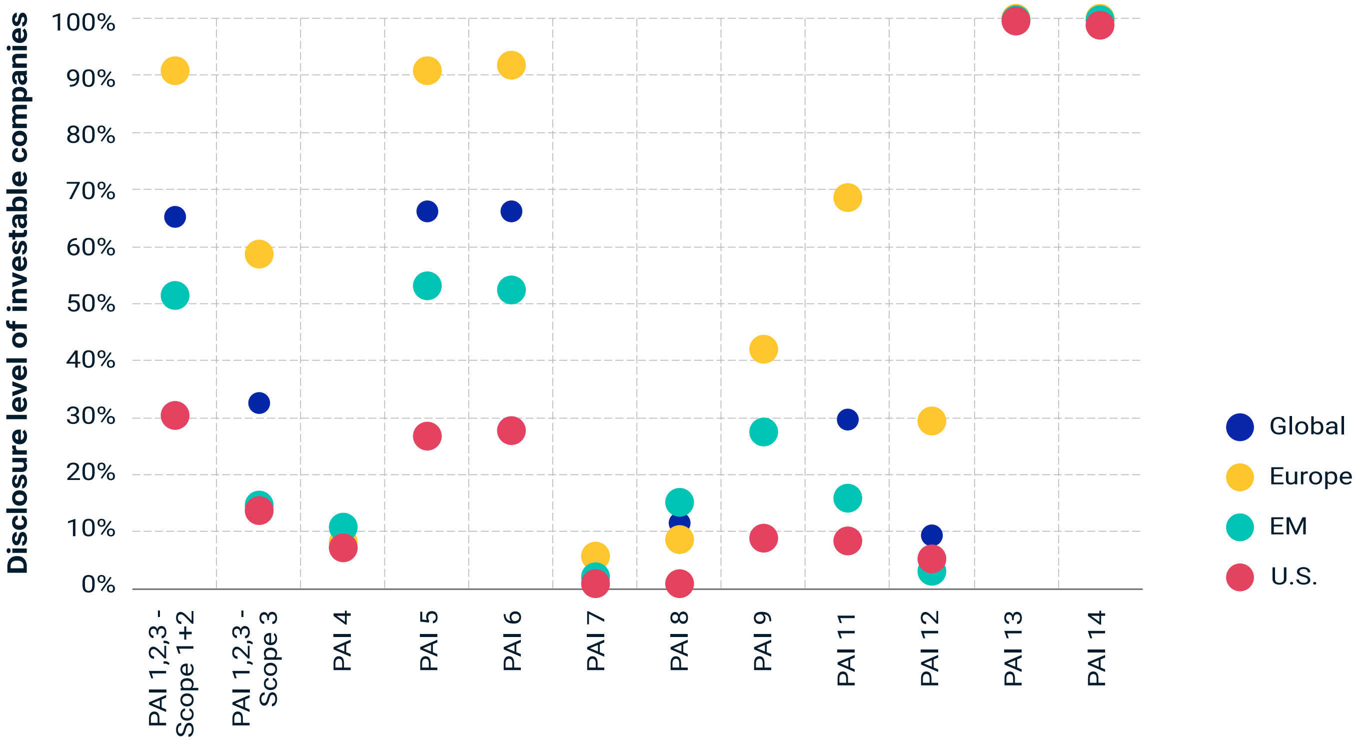
Exhibit 8: Plenty of choice in article 8, not so much in article 9



Number of funds: article 8 (11,369), article 9 (973). Data as of April 30, 2023. Source: MSCI ESG Research

For portfolio managers seeking to create PAI-optimized funds, disclosure levels are a key determinant. Assessing the large- and mid-cap investable universe revealed high dispersion on the disclosure of environmental PAIs such as emissions-based metrics (Scope 1-3). European companies led the way with over 90% of firms disclosing Scope 1 and 2 emissions. Notably, emerging markets exhibited higher disclosure levels versus the U.S., across Scope 1, 2 and 3 emissions, and were higher versus Europe on PAI 8 (emissions to water) disclosures. On social PAIs, gender pay gap (PAI 12) reporting was low across the board with just 3.1% of companies disclosing globally. At 30%, Europe had the highest disclosure rates for social PAIs, with the U.S. disclosing marginally more than emerging markets. Board-gender-diversity (PAI 13) disclosure was high across regions, though it should be noted that high disclosure does not necessarily equate to the boards of these companies having higher diversity than peers.

Exhibit 9: Environmental and social PAI disclosure levels

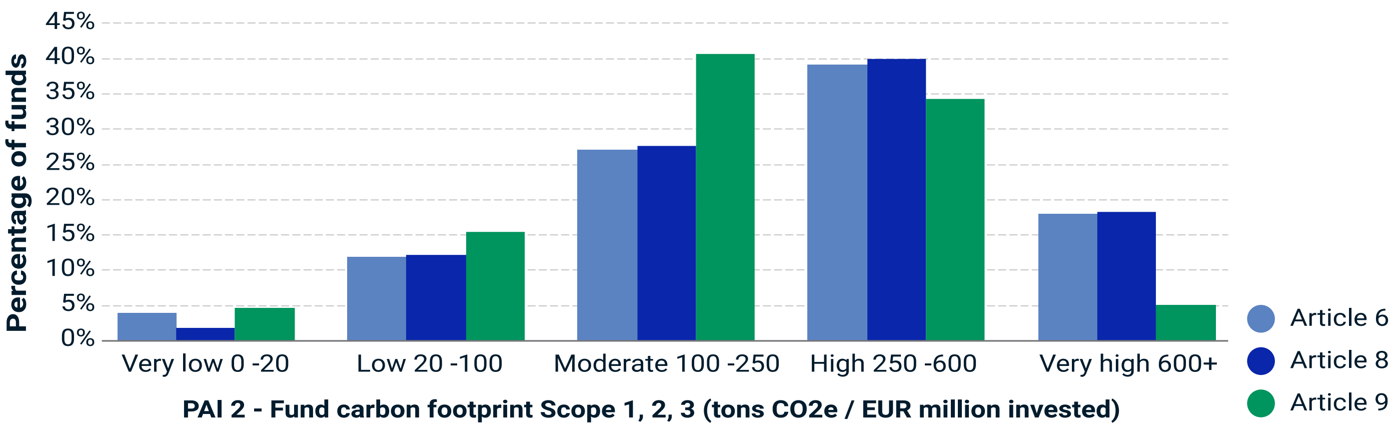


Based on PAI disclosure and MSCI ESG Research assessments of large- and mid-cap companies of regions represented by the MSCI ACWI, Europe, USA and Emerging Market Indexes. Number of companies per region: global (2,882), Europe (424), U.S. (625), emerging markets (1,373). PAIs are defined in Annex 1, Table 1 of Commission Delegated Regulation (EU) 2022/1288. Official Journal of the European Union, 2022. Data as of April 30, 2023. Source: MSCI ESG Research

Article 8 and 9 funds' performance on key Principle Adverse Indicators

Article 9 funds were distributed toward the lower end of the carbon-footprint ranges (PAI 2), with over 60% of these funds falling between the very low to moderate intensity categories. Conversely, over 80% of article 6 and 8 funds fell in the moderate to very high intensity ranges.

Exhibit 10: Funds' performance on carbon footprint (PAI 2)

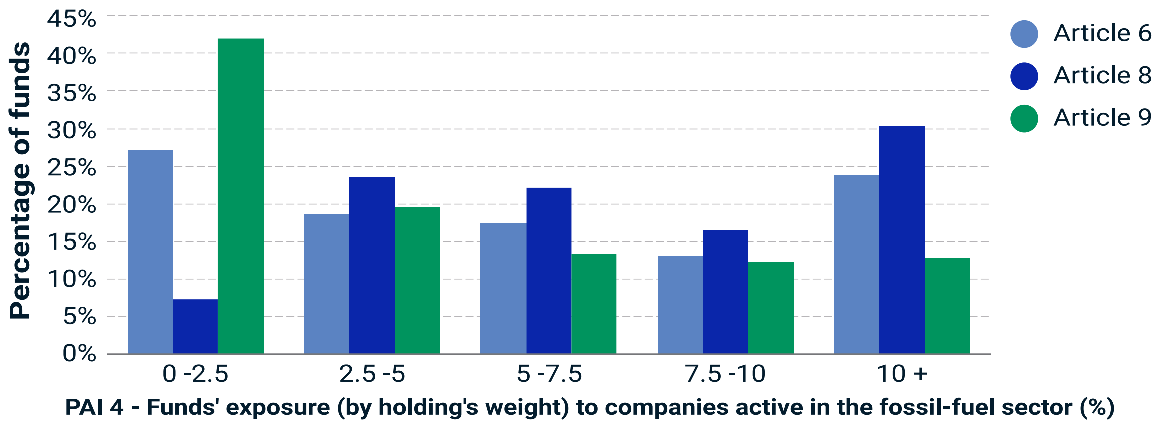


Sum of portfolio companies' total greenhouse gas (GHG) emissions (Scopes 1, 2 and 3) weighted by the portfolio's value of investment in a company and by the company's most recently available enterprise value including cash, adjusted to show the emissions associated with EUR 1 million invested in the portfolio. Number of funds: article 6 (20,917), article 8 (11,369), article 9 (973). Data as of April 3, 2023. Source: MSCI ESG Research

We observed a similar picture in funds' exposure to fossil-fuel sectors (PAI 4), where article 9 funds had the lowest weighted-average of holdings that were active in the fossil-fuel sector. This was largely due to these funds having emissions-based targets and/or fossil-fuel screens as part of their portfolio construction, while article 6 and 8 funds lacked such targets or screens.

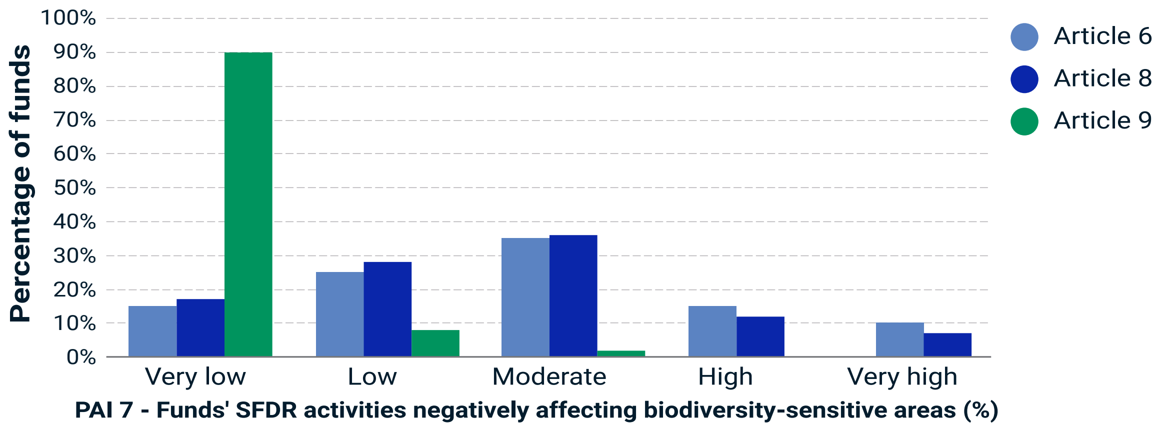
On PAI 7 (activities negatively affecting biodiversity sensitive areas) and PAI 13 (board gender diversity), article 9 funds have the least biodiversity adverse impact (Exhibit 12) and highest portfolio-weighted-average female directors exposure (Exhibit 13).

Exhibit 11: Funds' exposure to the fossil-fuel sector (PAI 4)



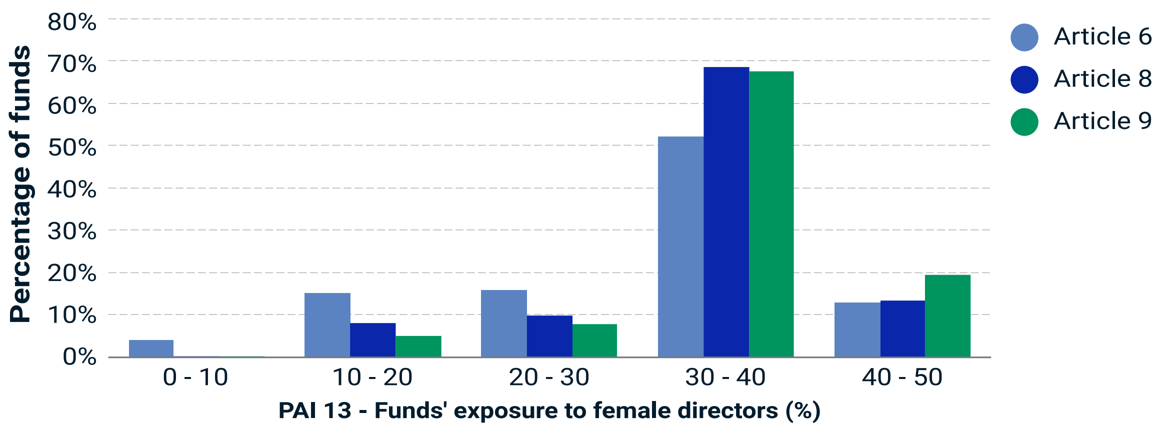
Sum of companies' weight in portfolio that have active fossil-fuel sector exposure. Number of funds: article 6 (20,917), article 8 (11,369), article 9 (973). Data as of April 30, 2023. Source: MSCI ESG Research

Exhibit 12: Funds' performance on biodiversity (PAI 7)



Sum of companies' weight in portfolio that have operations located in biodiversity sensitive areas and are involved in controversies with severe impact on the environment. Number of funds: article 6 (20,917), article 8 (11,369), article 9 (973). Data as of April 30, 2023. Source: MSCI ESG Research

Exhibit 13: Funds' performance on board diversity (PAI 13)



Portfolio-weighted-average of company female directors as a percentage. Portfolio weights are normalized when board gender diversity coverage is less than 100%. Number of funds: article 6 (20,917), article 8 (11,369), article 9 (973). Data as of April 30, 2023. Source: MSCI ESG Research

MiFID II **sustainability preferences**

Under revised rules that became effective on Aug. 2, 2022, MiFID II set out its own requirements to integrate sustainability considerations.[6] Under MiFID II, investment firms providing investment advice and portfolio-management services are required to consider sustainability factors and risks and the adverse impacts of their investments.

Key among the amendments introduced in MiFID II is the requirement that investment firms inquire about the individual sustainability preferences of their clients. Based on data disclosed by asset managers in the EET, we found that of the 13,419 European funds analyzed, approximately 47% are considering end-client sustainability preferences in the type of investment vehicles they offer. Of the universe of EU-domiciled funds, of which 6,603 are article 8 or 9 funds, a significantly higher percentage (approximately 92%) are considering end-client sustainability preferences.

To be able to recommend suitable products, investment firms must confirm whether a client has sustainability preferences, and if so, to what extent, one or more of the following criteria should be integrated into their portfolios:

- Financial instruments or products with a minimum proportion of sustainable investments that qualify as environmentally sustainable under the EU Taxonomy ("EU Taxonomy-aligned investments")
- Financial instruments or products with a minimum proportion of sustainable investments as defined under Article 2(17) of SFDR ("Sustainable investments")
- Financial products or instruments that consider PAIs on sustainability factors ("SFDR PAI indicators"), where those considerations are determined by the client or potential client

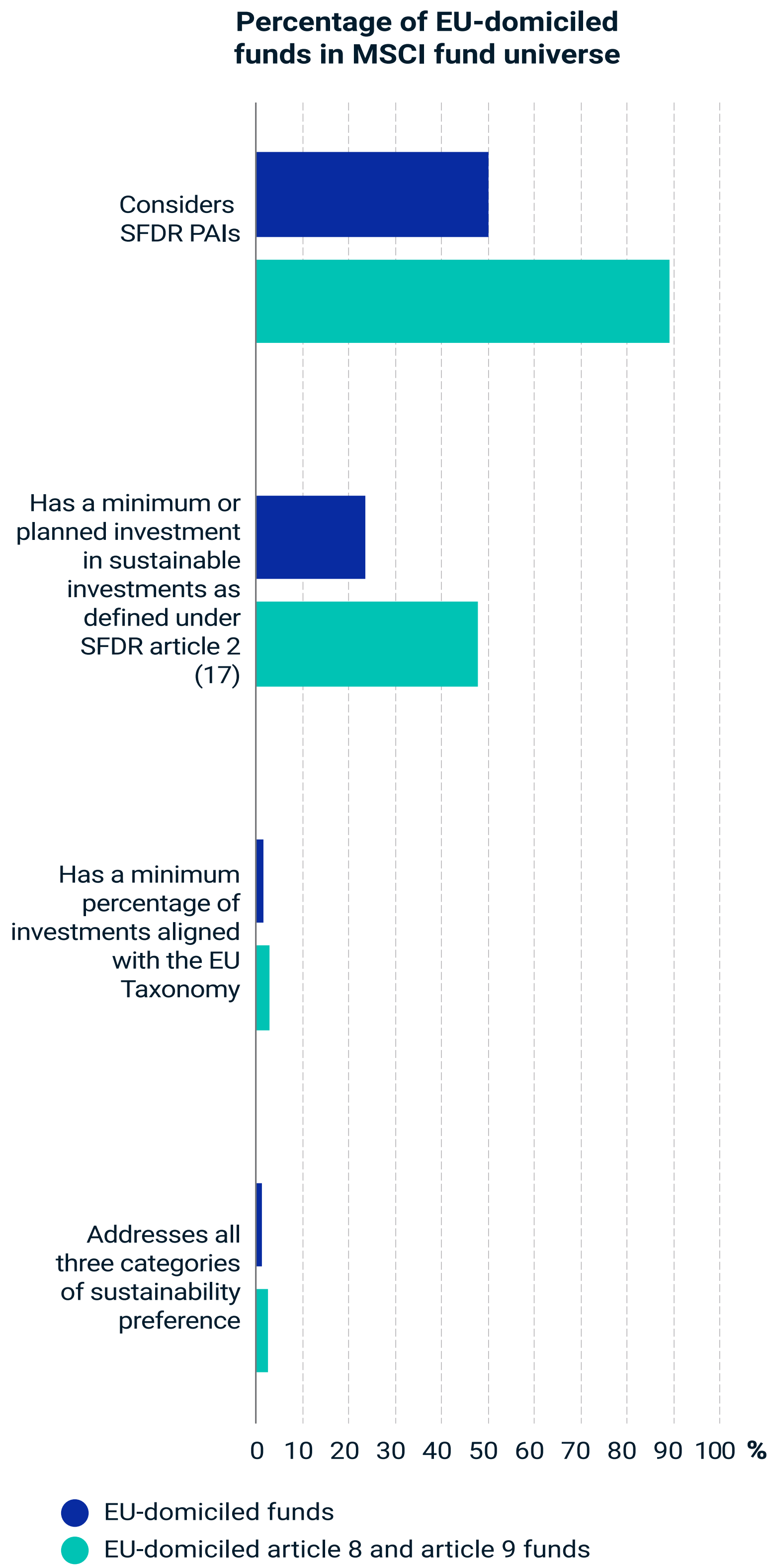
6 “Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021, amending Delegated Regulation (EU) 2017/565 regarding the integration of sustainability factors, risks and preferences into certain organizational requirements and operating conditions for investment firms.” Official Journal of the European Union, August 2021.

7 “Regulation (EU) 2019/2088 of the European Parliament and of the Council of 17 November 2019 on Sustainability-related Disclosures in the Financial Services Sector.” Official Journal of the European Union, December 2019.

Based on data disclosed in the EET as of April 30, 2023, we found that over half of European-domiciled funds were considering (committing to reduce or mitigate) at least one SFDR PAI in their investment strategy (see Exhibit 14). When narrowing down the universe to article 8 and 9 funds only, close to 90% of them disclose that they consider SFDR PAIs in their investment strategy. Slightly less than 25% of all European-domiciled funds and just under 50% of article 8 and 9 funds in the same universe had a minimum or planned investment in sustainable investments as defined under SFDR Article 2(17). For article 8 and 9 funds domiciled in the EU, less than 10% disclosed a minimum percentage of investments aligned with the EU Taxonomy. This may be unsurprising, however, given 2023 is the first year in which non-financial companies are required to disclose the percentage of activities aligned to the EU Taxonomy.

For investment products based on SFDR PAIs or EU Taxonomy-related preferences, investment managers can base investment decisions on pre-defined metrics and criteria set forth by the regulators in the SFDR and EU Taxonomy regulations. The definition of "sustainable investment" under SFDR Article 2(17), however, is less defined. Last year, we proposed a possible approach to defining metrics and criteria for measuring sustainable investments.

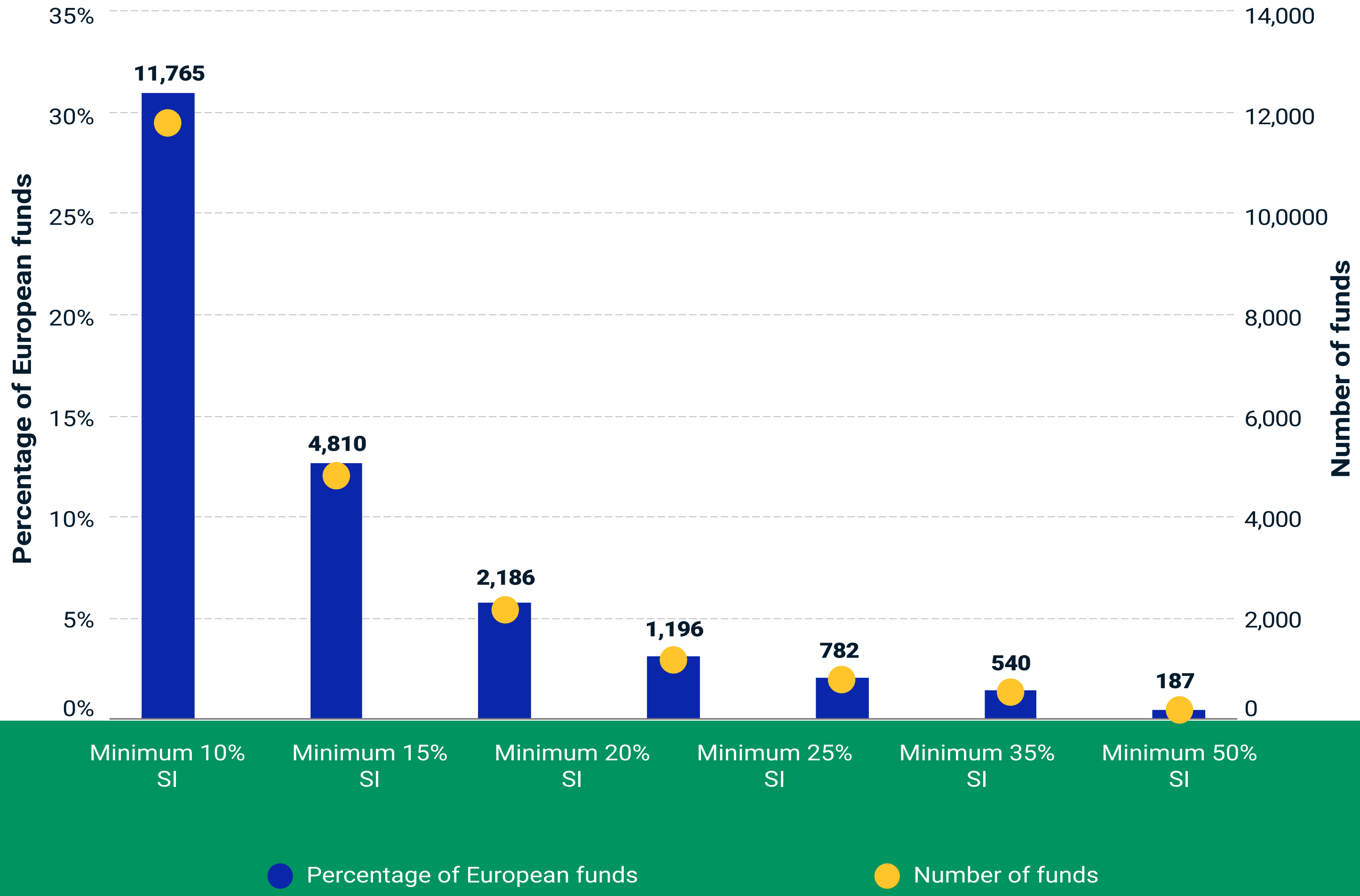
Exhibit 14: Percentage of EU funds considering MiFID II categories of sustainability preference



Number of EU-domiciled funds: 13,419; number of EU-domiciled article 8 and 9 funds: 6,603. Data as of April 30, 2023. Source: MSCI ESG Research and EET disclosures

Using the percentage of a fund's market value exposed to issuers that meet the criteria to be considered a sustainable investment under SFDR Article 2(17) (and based on MSCI's interpretation of the three building blocks: good governance practices, do no significant harm and positive contribution to an environmental or social objective), we determined that approximately 69% of European funds have 0-10% of investments passing as sustainable investments. The percentage of European funds with a minimum of, for example, 15% of the fund's market value exposed to issuers meeting MSCI's sustainable investment criteria drops to approximately 12% and continues to decrease as the minimum sustainable investment percentage increases (see Exhibit 15).

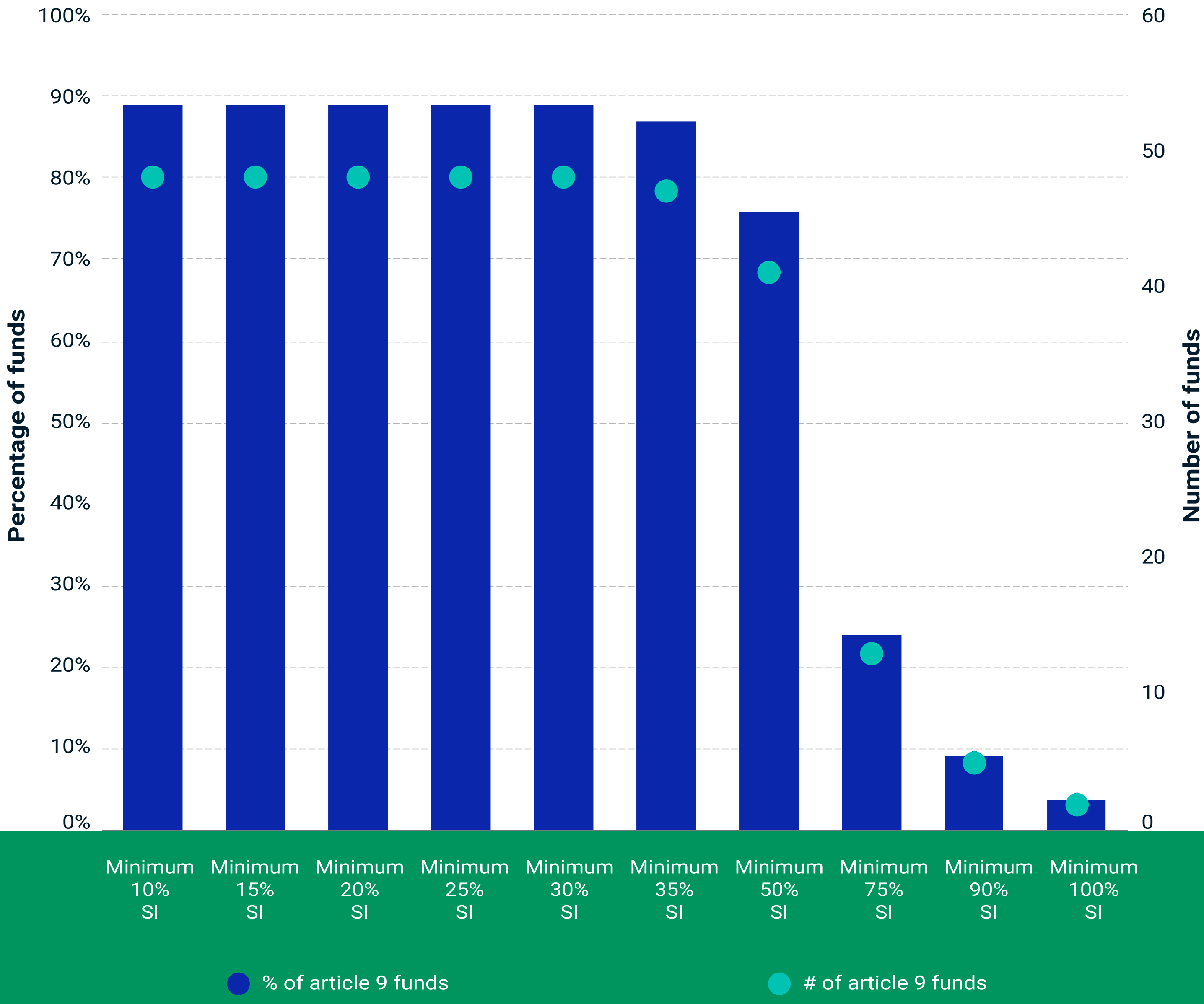
Exhibit 15: European funds with minimum percentage of their market value exposed to issuers meeting MSCI's criteria for sustainable investment (SI)



The European Securities and Markets Authority (EMSA) notes in its final report on its updated guidelines under MiFID II, that where a client expresses preferences in terms of the "minimum proportion" of sustainable investments as defined under SFDR Article 2(17), firms can collect this information by minimum percentage as compared to an exact percentage (e.g., minimum 20%, minimum 25%, etc.). Number of funds: 38,040. Data as of April 30, 2023. Source: MSCI ESG Research

Based on data disclosed by fund managers in the EET, we found that of the 662 funds disclosing as article 9, less than 10% reported the percentage of holdings that they assess to be sustainable investments under SFDR Article 2(17); though product-level periodic reporting requirements had not yet begun. Of these funds, the percentage of sustainable investments, as reported by fund managers, dropped significantly after passing the 50% sustainable investment threshold (see Exhibit 16). Per clarifications from the European Supervisory Authorities (ESAs) in June 2022 and May 2023, financial products that have "sustainable investment" as an objective should only make sustainable investments (a designation not defined by the EU) and fund managers must disclose the methodologies used to carry out their assessments.

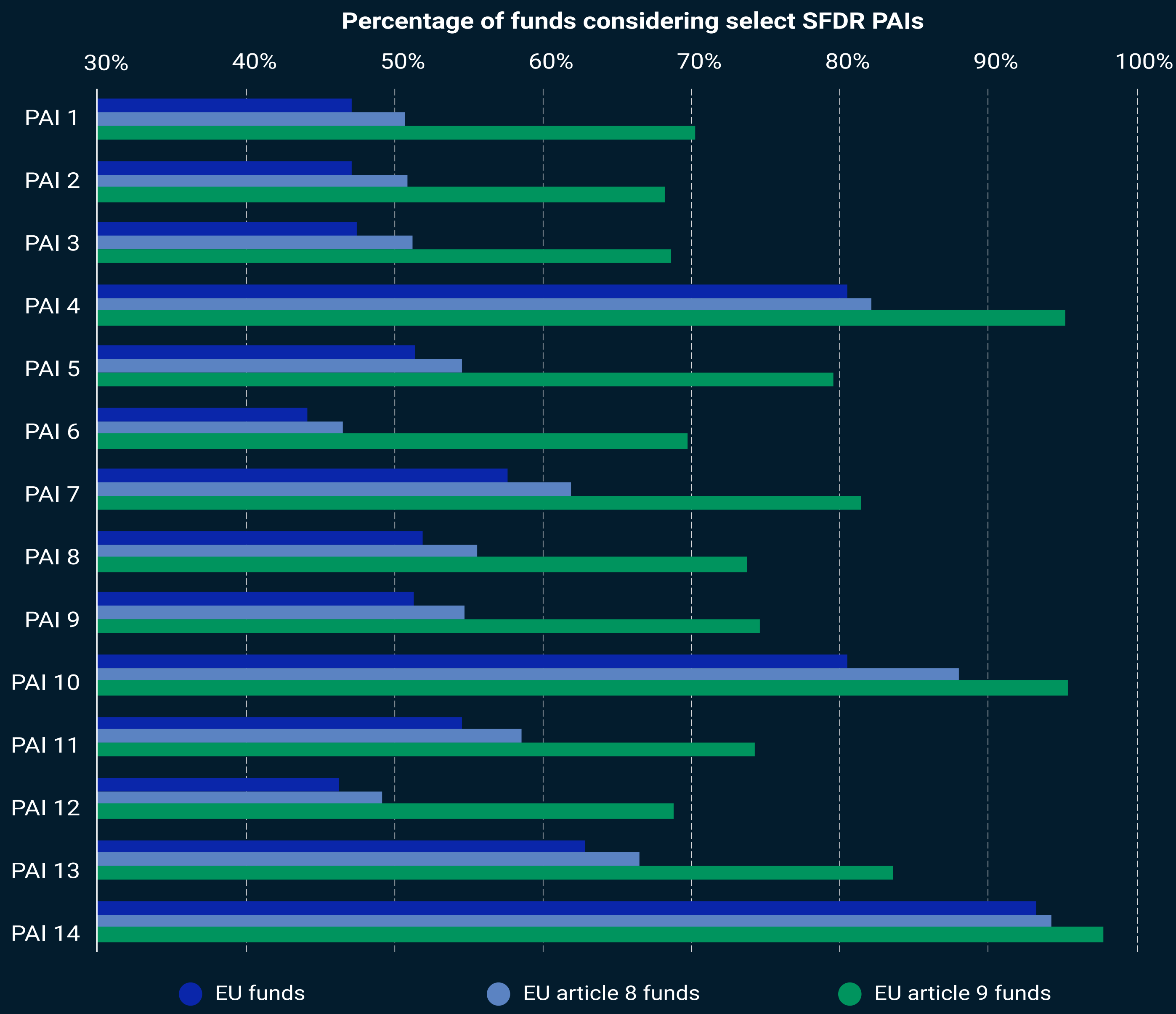
Exhibit 16: EU article 9 funds disclosing percentage of sustainable investments



Number of funds: 54. Data as of April 30, 2023. Source: MSCI ESG Research

For funds disclosing they consider SFDR PAIs in the EET, MSCI ESG Research found that consideration of involvement-type adverse impact indicators is more likely than consideration of quantitative indicators for which thresholds are not prescribed by the SFDR regulation. Specifically, 80% of funds disclose considering exposure to companies active in the fossil-fuel sector (PAI 4) and 93% consider exposure to controversial weapons (PAI 14). On the other hand, approximately 47% of funds consider exposure to GHG emissions (PAI 1) and 51% of funds consider exposure to companies with non-renewable energy consumption and production (PAI 5). And across the board, EU-domiciled article 9 funds have committed to manage or mitigate PAIs more so than funds without sustainable investments as their objective, likely driven by the requirement to assess the portfolio against the principle of "do no significant harm" by considering the PAIs.

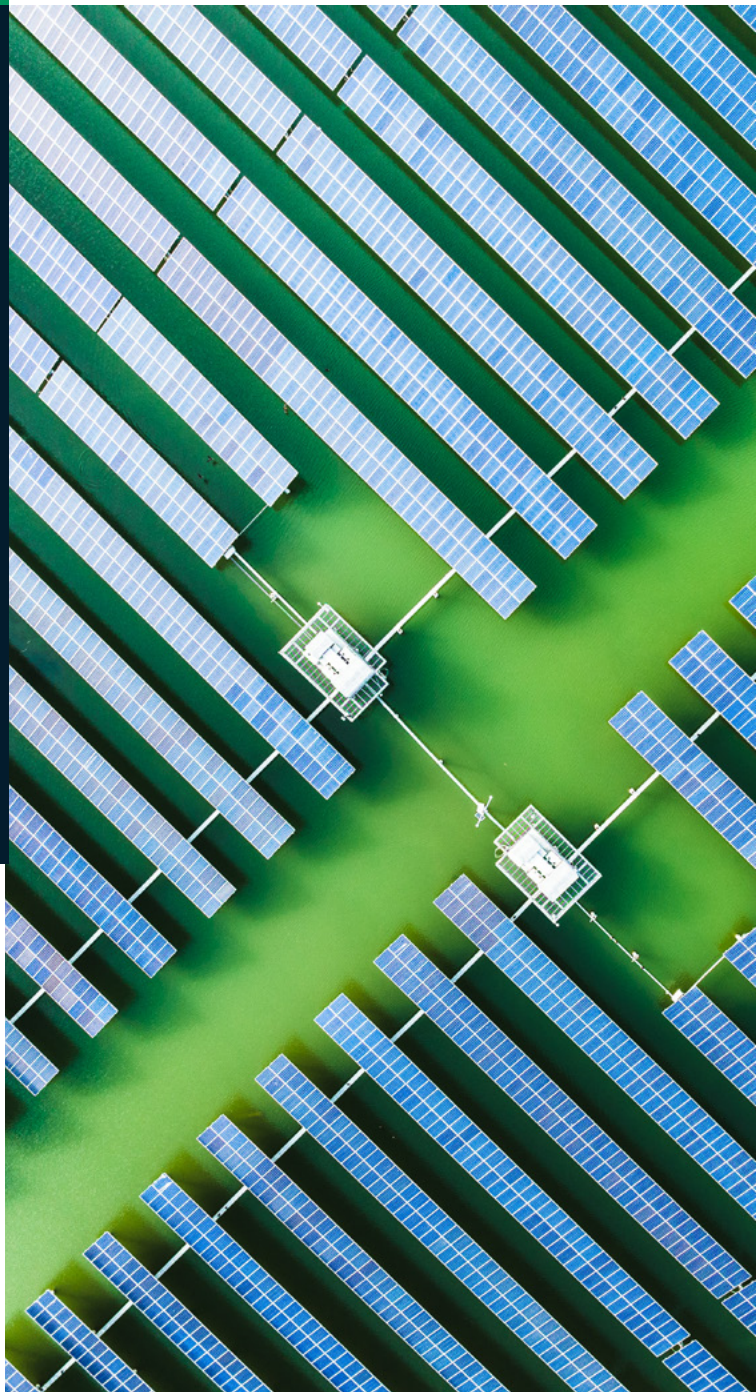
Exhibit 17: Consideration of select adverse-impact indicators among EU funds having disclosed a commitment to reduce or mitigate at least one SFDR PAI



Number of unique EU-domiciled funds: 6,709; number of article 8 funds: 5,978, number of article 9 funds: 662. PAIs are defined in Annex 1, Table 1 of Commission Delegated Regulation (EU) 2022/1288. Official Journal of the European Union, 2022. Data as of April 30, 2023. Source: MSCI ESG Research and EET disclosures

Conclusion

The state of disclosures, product choices and sustainability preferences will continue to evolve as the regulatory environment in Europe remains in flux. And while that presents a confluence of challenges for investment managers, from portfolio construction to sustainability reporting, opportunities may also arise as end investors continue to become more attuned to how sustainability is integrated in the investment process.



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