Economics & Finance

Zero Carbon Analytics

Briefing · July 2024

EU's sustainable finance rules underpin global leadership

Key points:

- Europe is a leader in sustainable finance globally, driven by high consumer demand and strong regulations. Europe is the domicile of almost 90% of sustainable funds by assets under management, and 85% of European investors are interested in sustainable investing.
- The European Union is a key driver of strong regulations, introducing an action plan on sustainable finance in 2018. The SFDR is a key part of this framework and aims to improve transparency in sustainable investments.
- The EU's sustainable finance rules may play a key role in whether the EU achieves climate neutrality by 2050. To do this, the EU will need to invest EUR 620 billion more annually until 2030 than it did over 2011-2020, with around 80% of this needing to come from the private sector.
- SFDR-covered funds reached USD 13 trillion in Q1 2024, with Article 8 funds growing 28% YoY and constituting 57% of the SFDR market. However, Article 9 funds - which have the most stringent sustainability criteria - hold the smallest share of 2.9%.
- The EU leads the world in green bond issuance, raising USD 1.633 trillion to date. This amount is nearly equivalent to the total green bonds issued by the rest of the world.
- The European Commission is reviewing the SFDR following criticism around the risk of greenwashing, inconsistencies in fund categorisations, and a lack of clarity over key terms.

EU sustainable finance rules

Europe is a global leader in sustainable finance, driven by strong regulations and consumer demand for green products. Interest in sustainable investing in the region is high and rising, with 85% of European investors interested in sustainable investing and 66% reporting increased interest over the past two years, according to Morgan Stanley.

The European Union is a key driver of strong regulations on the continent. The European Commission introduced an action plan on sustainable finance in 2018, with the aim of directing more investment to sustainable activities. A key regulation in the plan was the Sustainable Finance Disclosure Regulation (SFDR), which aims to improve transparency in the investment space and help investors make informed decisions.

In 2019, the EU introduced the Green Deal, with the goal of making the bloc climate neutral by 2050. Recent estimates show that the EU will need to invest an additional 620 billion each year until 2030 than it did over 2011-2020, according to the EU's sustainable finance

advisory body.[1] A substantial share of this investment will have to come from the private sector, as estimates suggest that only 17-20% of the required funds for energy and climate interventions are expected to be covered by public investment.

The SFDR could play a key role in whether the EU achieves its Green Deal objectives, including those related to climate mitigation. Around 78% of the EUR 620 billion in necessary annual investments needs to be directed towards climate mitigation until 2030 to achieve net-zero, according to the advisory body. The European Commission also estimates that clean energy investment must increase by 60% above current levels to align with net-zero.

What is SFDR?

SFDR is a transparency framework that mandates financial market participants to disclose sustainability information about the funds they make available to investors. It aims to empower investors interested in supporting sustainability objectives to make well-informed decisions when allocating their capital. SFDR requires market participants to classify their funds within three categories:

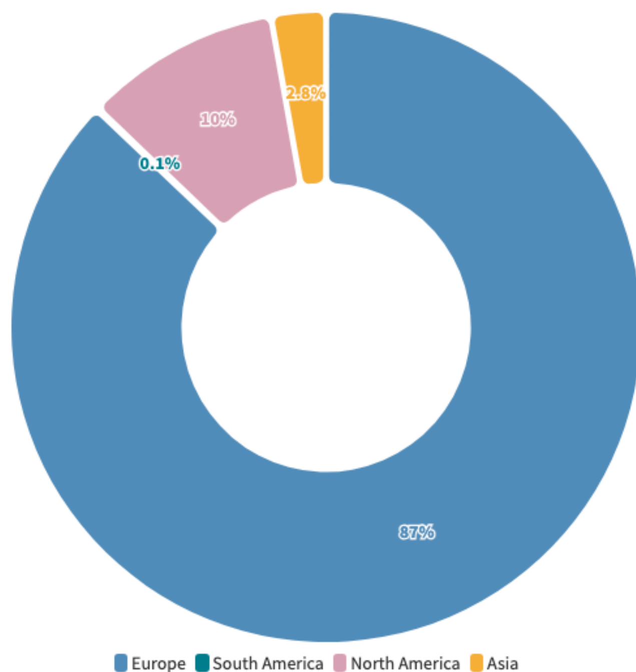
- **Article 9** funds are commonly referred to as "dark green" funds, as their core objective is sustainable investment, which is **defined, measured and monitored.**
- **Article 8** funds are known as "light green" funds, as they do not have sustainability as their primary objective, but still promote environmental or social characteristics.
- **Article 6** funds do not necessarily focus on environmental, social and governance (ESG), yet companies offering them may choose to publish a statement outlining their carbon footprint and adherence to global ESG standards.

Europe leads in sustainable funds

Three years have passed since the SFDR came into force. Looking at assets under management (AUM), Europe held a leading position in 2023, with 87% of sustainable funds by AUM domiciled on the continent.[2]

[1] According to the Monitoring Capital Flows to Sustainable Investments: Intermediate report published by the European Commission in 2022.
[2] Morningstar classifies a fund as sustainable if "...in the prospectus or other regulatory filings it is described as focusing on sustainability, impact investing, or ESG factors. Funds must claim to have a sustainability objective, and/or use binding ESG criteria for their investment selection. Funds that employ only limited exclusions or only consider ESG factors in a nonbinding way are not considered to be a sustainable investment product."

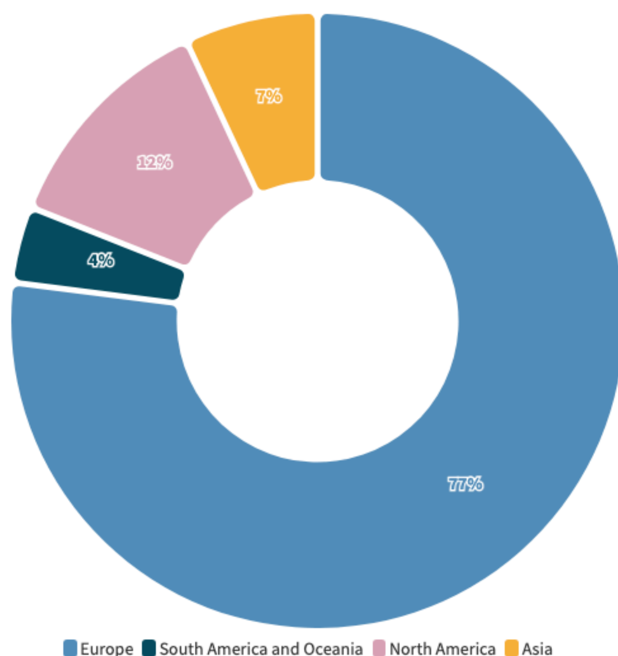
Fig. 1: Sustainable funds' domicile by AUM (2023)



Source: Morgan Stanley Institute for Sustainable Investing, Sustainable Reality 2023

By fund count, 77% of [the world's sustainable funds were based in Europe]() in the first half of 2023, compared to 12% in North America and 7% in Asia.

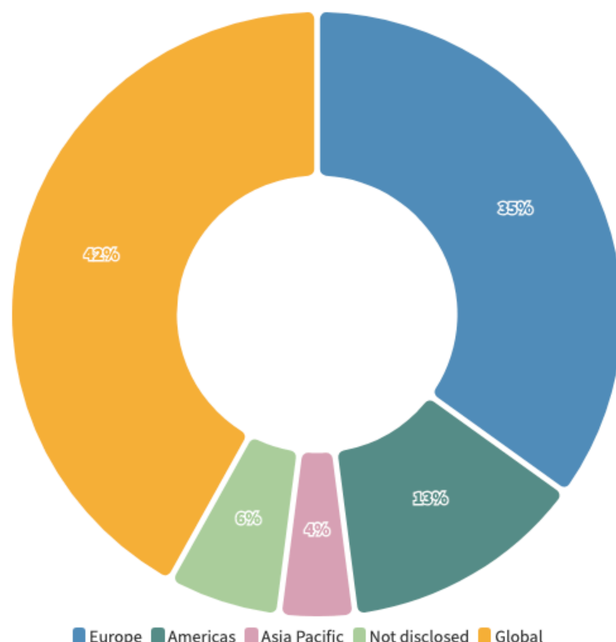
Fig. 2: Sustainable funds' domicile by number of funds (H1 2023)



Source: Morgan Stanley, Sustainable Funds Return to Outperformance in First Half of 2023

However, this does not mean that investing in European assets is the primary focus of all European sustainable funds. The majority of funds have a global investment universe, allowing them to invest in equities and bonds from various regions.

Fig. 3: Sustainable funds investment universe by AUM (2023)



Source: Morgan Stanley Institute for Sustainable Investing, Sustainable Reality 2023

Recent data shows that funds in Europe had inflows of USD 10.9 billion in the first quarter of 2024, more than double the subscriptions in the previous quarter. In comparison, the US, the second largest sustainable fund market, experienced record outflows of USD 8.8 billion. The inflows in the European market were mostly fueled by bonds - sustainable bond funds saw a 244% increase in net flows compared to the previous year, totaling USD 19.6 billion.

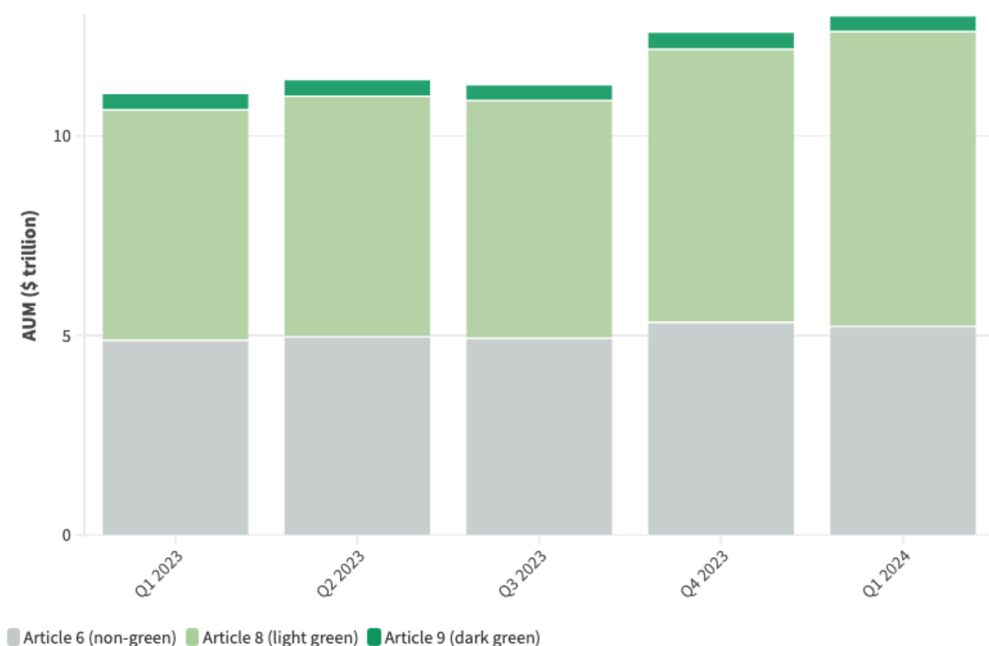
Growth of the SFDR fund market

In Q1 2024, total funds under SFDR reached a record USD 13 trillion, with Article 8 assets accounting for USD 7.4 trillion (57%) and Article 9 funds stabilising at USD 380 billion.[3] Article 8 and 9 funds now represent 60% of the SFDR market, up from 56% in Q1 2023, meaning two-thirds of total funds covered by SFDR claim ESG credentials.

Article 8 funds had the highest annual growth between Q1 2023 and Q1 2024 of about 28%, compared to the relatively flat growth of about 7% in Article 6 funds and a slight decrease in Article 9 funds of about 2.6%. Despite the decrease, Europe is still leading in the Article 9 market.

[3] Zero Carbon Analytics analysis, based on Bloomberg Intelligence SFDR Barometer: 1Q 2024, BI's new data covers over 23,000 SFDR funds.

Fig. 4: SFDR fund market (2023-2024), share of AUM per fund category



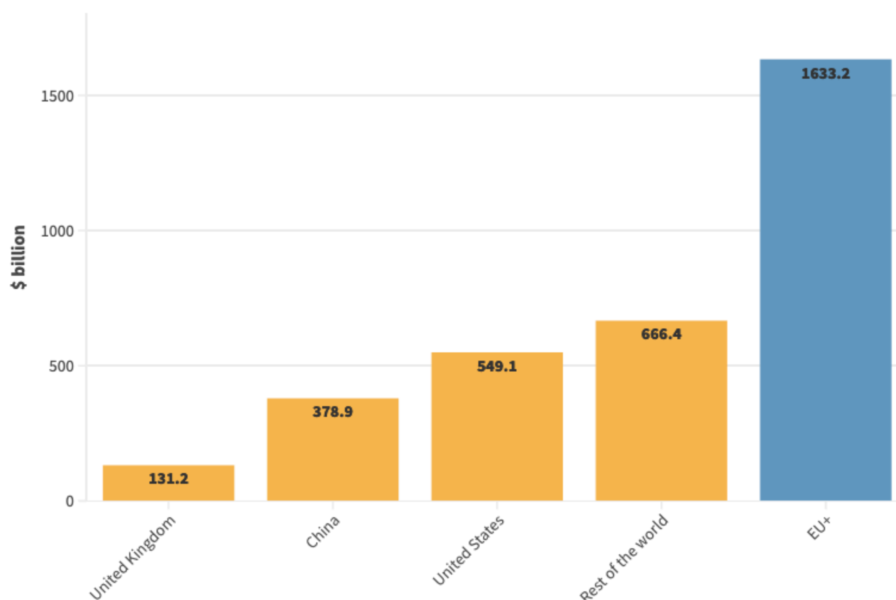
Source: Zero Carbon Analytics Analysis, Bloomberg Intelligence SFDR Barometer: Q1 2024

Other assets: Green bonds

The EU is the largest issuer of green bonds to date. Out of all sustainable debt instruments, green bonds are considered to have the highest impact credentials. Research has shown that green bonds are correlated with reduced carbon emissions and increased renewable energy production.

While all regions globally saw an increase in green bond issuance during 2023, the EMEA region saw the largest growth of 24%. The region returned to making up over half of global issuance, which was not the case over the past two years. This might demonstrate that the European market is moving towards more transparent instruments with impact potential.

Fig. 5: Total green bonds issued as of Q1 2024 (USD billion)



Source: Zero Carbon Analytics Analysis, BNEF, Sustainable Finance Data, last updated May 31 2024
Note: EU+ includes EU-27, Switzerland and Iceland

Challenges and areas for improvement

Despite the growth of funds under SFDR and the fact that several major economies including Canada, Japan, and Australia have introduced or proposed similar regulations, the regulation has faced criticisms over the years. These criticisms often centre around:

- **Varying ambition of Article 9 funds:** Some asset managers point out the misconception that the Article 9 category includes only impact funds when in reality, not all Article 9 funds are impact-focused. Impact funds are generally considered to have ambitious social or environmental goals. Some asset managers advocate for clear criteria to identify impact funds under Article 9 and propose a distinct impact label, along with reporting on both positive and negative impacts, to improve investor decision-making.
- **Article 8 and 9 used as proxies for sustainability labels:** Research shows that fund name and category changes are not always accompanied by corresponding portfolio adjustments. One in seven funds labelled as sustainable has a carbon intensity higher than the average across all investment funds. The European Commission introduced Article 6, 8 and 9 as transparency categories, however they started to function as label proxies.
- **Lack of harmonisation in definitions:** Financial institutions define sustainable investments and environmental & social characteristics themselves when categorising their assets as Article 8. Critics have raised concerns that due to this, Article 8 funds risk becoming catch-all funds with widely varying sustainability attributes. To address the inconsistency, SFDR could be aligned with the EU Taxonomy, which provides a classification system for environmentally sustainable economic activities. This change could mobilise more capital towards projects and firms that significantly contribute to climate mitigation.
- **Barriers in channelling funds into emerging markets:** Emerging market and developing economies (EMDEs) face significant barriers in accessing clean energy investments, accounting for only 15% of global clean energy spending, according to the IEA. The SFDR inadvertently creates more barriers for EMDEs, as many firms in these regions fail to meet the EU's 'do no significant harm' criteria, which excludes

them from European investor portfolios. To address this, adjustments to SFDR could consider enhancing the consideration of transition finance, fostering cooperation with national green taxonomies in EMDEs like Rwanda or Kenya, and revising principal adverse impact indicators specifically for cases where sustainable activities take place outside of Europe.

In September 2023, the European Commission announced a review and public consultation on the SFDR to understand its shortcomings and areas for improvement. The outcome of the consultation, with respondents including public bodies, national authorities and financial market participants, was analysed by Ramboll. Over 60% of those surveyed expressed a preference for a product categorisation system, suggesting that SFDR might transform into a labelling scheme.

In response to the consultation, Europe's financial watchdogs proposed substantial changes to the bloc's rules on sustainable investment labelling in June, aiming to provide simpler, clearer information and reduce the risk of greenwashing. The European Commission is reviewing the proposals and the final amendments are expected to be implemented after January 1, 2025, though an earlier date is possible.