CORPORATE & INSTITUTIONAL

Sustainability Markets Insights

Down but not out:

How sustainable are sustainability commitments?

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Edition 2

LLOYDS

Down but not out

Introduction

With '*Brussels under pressure to curb green agenda in response to Trump*' (FT, 26 Jan 25), and as '*Hedge funds slam 'enormous burden' of new ESG requirements*' (Bloomberg, 6 Feb 25), in this edition of Sustainability Markets Insights we look beyond the headlines.

We investigate the numbers to see how things are faring across three bellwethers for sustainability commitments:

- Funds adopting the FCA-governed Sustainability Disclosure Requirements (SDR).
- EU's Sustainable Finance Disclosure Regulation (SFDR) classifications.
- Climate-related financial alliances.

The article explores reasons behind the downturns and looks to where the upside might lie. While much can seem downbeat, we find there is evidence that sustainability is still a relevant topic to investors and issuers alike.

1. UK Sustainability Disclosure Requirements label adoptions

The headline: 'SDR Improvers label sees pick up after a slow start

(Responsible Investor, 20 January 2025)

The FCA introduced product labelling criteria for funds in the UK in 2024 to combat greenwashing and build consumer trust. It represents a first of its kind labelling regime (see Section 2 for EU categorisation developments). To qualify for a label at least 70% of the product's assets must be in line with the label's sustainability objective and must have robust evidence for selecting those assets.

•The FCA's Sustainable Disclosure Requirements (SDR) requires investment funds to meet criteria to qualify for one of the four Sustainability labels: Impact, Focus, Mixed Goals or Improver.[1]

•Related to using a Sustainability label or to meeting naming and marketing rules, the FCA reviews pre-contractual disclosures in light of the new regulation, rather than approving the label use itself.

•Initial estimates for label adoption were around 400 funds, based on the number of UK-domiciled funds with sustainability-related titles.[2] This has now been revised to 150 funds through to the end of 2025.[3]

•Challenges of adoption have been reported, particularly for credit funds.

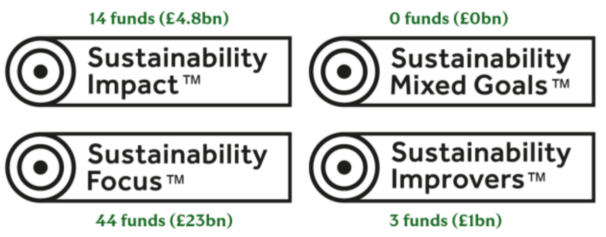
[1] FCA. *Sustainability disclosure and labelling regime*, data accessed 13 February 2025
[2] Morningstar. *UK Sustainability Disclosure Requirements Through the Looking Glass*, 9 January 2024
[3] Morningstar. *Global Sustainable Fund Flows: Q4 2024 in Review*, 27 January 2025

What's the data saying on SDR?

Five months after firms could start using the Sustainability labels, 61 funds with a total of £28bn AUM had adopted SDR labels.

Figure 1: SDR label adoption as of 22 January 2025

"The labelling regime has proved challenging to implement and has had a low initial uptake"



Source: Morningstar. Global Sustainable Fund Flows: Q4 2024 in Review, 27 Jan 2025

Where the upside might lie

As a result of the FCA's sustainability disclosure and labelling regime, we've seen some firms review the positioning of sustainability in funds' names and strategies.[4] As this sits alongside the anti-greenwashing rule, this is not a surprise. Implementation has had setbacks though those funds that are committed to sustainability are complying, adopting labels and pursuing objectives in line with their firms' policies and their clients' mandates.

Ones to watch

Now that examples have been set, how will funds choose to adapt – their name, their asset allocation and/or the adoption of a Sustainability label. What will this mean for sustainable investment demand and how will sustainability performance be measured?

2. EU Sustainable Finance Regulation

The headline: 'ESMA and SFDR: another looming identity crisis for Europe's ESG funds?' (Insurance & Pensions Europe (IPE), 4 February 2025)

As positioned in the January edition of Lloyds' Sustainability Markets Insights, taxonomies and regulation are supporting a drive for language consistency. 2025 was always set to be a transformative year for the EU's sustainable finance regulation due to the SFDR consultation results, ESMA naming rules and CSRD reporting.

The next steps for Sustainable Finance Disclosure Regulation (SFDR) are now bumping up against a more large-scale review, known as the EU 'Omnibus' package. The Omnibus proposal seeks to consolidate and align the EU's sustainability legislation to reduce the regulatory burden on businesses. Many would be a fan of this initiative, though some are concerned about unwinding good work done and delaying investment.[5] In amongst this, two key updates have been published by the EU Platform on Sustainable Finance:

- In December 2024, a proposal for the SFDR category guidance for funds, not dissimilar to the SDR labels in the UK. Here, the proposal is for a product categorisation scheme with themes named: Sustainable, Transition, ESG Collection and Unclassified.[6]

[4] Responsible Investor. *More funds meet SDR deadlines amid slow start to UK label regime*, 3 December 2024

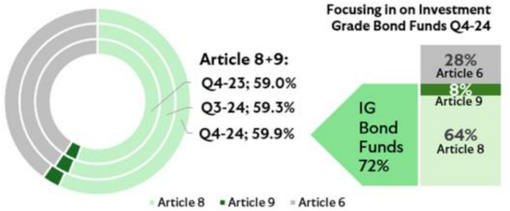
- In February 2025, related to the EU Taxonomy's usability and data, proposals were made to a) reduce the corporate reporting burden, b) simplify the Green Asset Ratio, c) update the assessment process for the Do No Significant Harm (DNSH) criteria, and d) streamline the approach for small and medium-sized enterprises (SMEs).[7]

All to say, there's a lot of movement, and that's without mentioning the EU Green Bond Standard. Let's focus on what recent SFDR Article 8 and 9 fund data is telling us.

What's the data saying on SFDR?

The market share of Article 8 and 9 funds (those that opt into disclosing more about the funds' promotion and commitment to sustainability) has been consistent over the past year, at around 60% per figure 2.[8] Alongside this, in Q4 2024, Investment Grade Bond Funds were the product set with the highest proportion of Article 8 and 9 funds by asset value.

Figure 2: SFDR fund type breakdown by assets



Source: Morningstar. SFDR Article 8 and Article 9 Funds: Q4 2024 in Review, 29 January 2025

Where might the upside lie

Growing clarity around how ESG terms can be used means funds updating their names to better align with their investment strategies in the context of the ESMA ESG-related fund naming guidelines, ensuring that fund names are fair, clear and not misleading. Within the population of Article 8 funds, 71 removed ESG-related terms in their names versus 45 adding them.

The Article 8 classification captures a wide variety of portfolios, and the upside might lie in the trends associated with funds' sustainable investment proportions. In Q4 2024, 218 funds increased their targeted percentage of sustainability investment to between 5% to 45%. Notably, those with 0% sustainable investment target saw the largest outflows in Q4. Together these moves suggest a small increase in sustainability commitment within the Article 8 fund population, perhaps as it absorbs some of Article 9 assets.

[5] Edie. *We are deeply concerned': 150 civil society organisations oppose EU 'Omnibus' proposals*, 5 February 2024
[6] EU Platform on Sustainable Finance. *Categorisation of products under the SFDR: Proposal of the Platform on Sustainable Finance*, December 2024.
[7] EU Platform on Sustainable Finance, *Simplifying the EU Taxonomy to Foster Sustainable Finance*, 5 February 2025
[8] Morningstar. *SFDR Article 8 and Article 9 Funds: Q4 2024 in Review*, 29 January 2025.

Ones to watch

The European Commission aims to publish Omnibus details on 26 February 2025. Expect global media coverage on this as investors, lawyers, banks, corporates and consultancies navigate the changes.

How EU disclosure regulation (Article 6, 8 and 9) interacts with the proposed product categorisation (Sustainable, Transition, ESG Collection and Unclassified) themes, and the fund naming rules (80% asset alignment with ESG-key term) laid out by ESMA. How will supply side respond?

3. Climate-related financial alliances

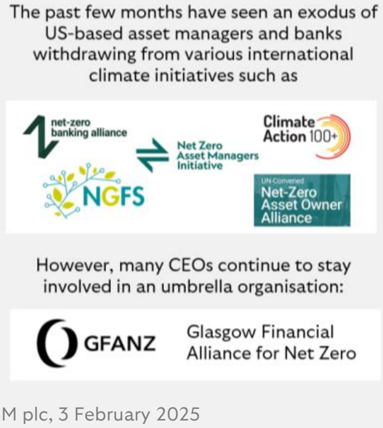
The headline: 'Big Banks Quit Climate Change Groups Ahead of Trump's Term' (New York Times, 20 January 2025)

Climate-related financial alliances exist to facilitate action in the climate space, typically designed around organisation type: central bank, corporate, asset manager or commercial bank for example. Through pre-competitive knowledge sharing and pilots amongst peers, the secretariat brings together guidelines and principles to support widespread integration.

Membership brings with it a level of expectation. For example, the 135 members of the UN-convened Net Zero Banking Alliance (NZBA) sign up to commitments to establish sectoral emissions reduction targets for 2030 and disclose annually on progress.[9]

What's the data saying?

Figure 3: Financial institutions leave climate-related alliances



Source: LBCM plc, 3 February 2025

Where the upside might lie

Despite leaving the NZBA, CEOs have showed an intention to stay involved in the GFANZ Principals Group, the original umbrella organisation for several alliances. It's certainly encouraging that CEOs continue to see meaning in leadership dialogue about mobilising capital in support of accelerating the transition to a net zero global economy. However, gaps might arise for those responsible for updating policies and business practices within these same organisations, who miss out on opportunities to learn with market leaders.

The upside might lie in a renewed focus on financial institutions' key levers for change: mobilising capital and managing risk over time horizons that now include 2030, a key year for science-based targets. These initiatives and the increase in usable data has the potential to drive long-term success in the context of a low carbon economy.

Where might the upside lie

We can understand the tussle playing out in North America - how will this translate to other regions?

[9] UNEP FI. NZBA: *The Commitment*, accessed 11 February 2025

Conclusion

In this piece we have chosen several data points as barometers for commitments to sustainability. Naming rules and anti-greenwashing regulation are some of the most significant factors we expect to influence them, likely causing downwards motions but we argue, they're not out.

Considerable innovation and expectation has been put on the integration of sustainability in a short period of time. While there is a time of reckoning for ESG, we think sustainability ambitions will remain relevant for citizens, governments, companies and investors.

Demand for sustainable bonds continue even in the US,[10] and sustainable bond supply is showing resilience globally; January 2025 saw monthly issuance of green, social, sustainability and sustainability-linked labelled at their highest levels since January 2024, ranking fourth all-time highest.[11] We'll have our eyes on the 'ones to watch' highlighted in each section.

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All editions in the Sustainability Markets Insights series can be found at lloydsbank.com/sustainabilitymarketsinsights.

[10] Bloomberg. *Green bond spreads may outperform IG Corporates*, 7 February 2025. Accessed 10 February 2025
[11] Bloomberg. *Sustainable bond market opens 2025 with busiest month in a year*, 4 February 2025. Accessed 10 February 2025

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