CORPORATE & INSTITUTIONAL

Sustainability Markets Insights

Bumpy ride: Naming guidelines, indices and optimistic diversity

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LLOYDS

Naming guidelines, indices and optimistic diversity

Introduction

In amongst all the headlines, in Q1 2025 sustainable fixed income funds maintained positive momentum with $14bn of inflows, higher than any quarter in the previous year.[1] For investment grade bond funds, the proportion classified as Article 8 and Article 9 stayed constant at 72%.[2]

The resilience in the fixed income asset class bucks the trend though; across all asset classes there were $8.6bn of outflows from sustainable funds globally in Q1 2025 versus the $18.1bn inflow in Q4 2024[1], and the overall portion of Article 8 and 9 funds dropped from 60% to 58% of the market.[2]

In this overarching context, we explore the consequences of the European Securities and Markets Authority (ESMA) fund naming guidelines on funds and the use of sustainability-related indices, what this means for the investable universe and how these developments might drive investor behaviours.

ESMA guidelines on funds' names

ESMA's *guidelines on funds' names using ESG or sustainability-related terms* [3] (the Guidelines) have triggered a review of fund names and of the appropriateness of benchmark indices.[4] For example, in the first quarter of 2025, 116 European domiciled funds removed sustainability-related terms from their names and many more switched ESG terms in preparation for the implementation deadline for the Guidelines.[1]

Having come into force on 21 May 2025, the Guidelines state that EU-domiciled Undertakings for Collective Investment in Transferable Securities (UCITS) funds with sustainability- or transition- related terms in their name must comply with specific criteria.[3] This is to minimise the risk of greenwashing. For example, such funds must ensure 80% of their assets promote environmental or social characteristics, and depending on the specific terms used they might need to exclude companies with more than 50% of their revenue from activities related to fossil fuels.[3]

The result is that you can expect a better understanding of what it means to be a fund with terms such as *green*, *climate*, *impact*, *ESG*, *sustainability*, *responsible*, or *SRI* (Socially Responsible Investing) in their titles.

Key to the naming guidelines is that EU funds with sustainability-related names must seek to ensure they are not in breach of the exclusionary criteria specified for EU Paris-aligned Benchmark (PAB) or EU Climate Transition Benchmark (CTB) indices- again, which one depends on the terms used.[4] This requirement has, firstly, reshaped the methodologies of some sustainable indices so they conform to the EU regulated benchmarks.[5] Secondly, it has driven up demand for the benchmarks; the associated datasets provided support due diligence and compliance, and by using these benchmarks for a sustainable fund, tracking errors can be reduced.[6]

[1] Morningstar, April 2025. *Global Sustainable Fund Flows: Q1 2025 in Review*, accessed 28 April 2025
[2] Morningstar, April 2025. *SFDR Article 8 and Article 9 Funds: Q1 2025 in Review*, accessed 6 May 2025
[3] ESMA. *Guidelines on funds' names using ESG or sustainability-related terms*, accessed 15 May 2025
[4] Clarity AI, 5 September 2024 – modified 12 May 2025. *ESMA Fund Names Rule: Over Half of EU Funds Must Divest or Rename to Meet Compliance*, accessed 28 May 2025
[5] EU, 9 December 2019. *Regulation - 2019/2089 - EN - EUR-Lex*
[6] Invesco, 30 January 2025. *Can you satisfy climate objectives with low tracking error?*

What these updates mean for the universe of eligible companies:

Simply put, these updates mean the universe of eligible assets shrinks for funds in scope of the regulation. The objective of the Guidelines is to help asset managers understand and market sustainable products in a more consistent way, reducing the risk of greenwashing. This means the full investment chain can now be clearer on what it takes to be considered a sustainable asset. The next step will be growing the investable universe to support diversity and resilience.

Index construction rules impact the investable universe for a fund that chooses it as its benchmark. Many fund managers have been checking there's still a strong fit with their investment objective and criteria. In some cases, switches are being made. Indices are more than just measuring sticks – they shape markets, capital flows, and portfolio construction. And that means they influence yields and relative performance.

How might that drive behaviours for investors?

Given how far we've come it's hard to imagine this - though a pessimistic path could see investors withdraw from the integration of sustainability. In the EU, this would mean removing sustainability-related labels from fund names. Ignoring sustainability-related data, objectives and benchmarks would likely open up your investable universe as you'd have fewer constraints imposed upon the portfolio.

An optimistic path – and one that wouldn't be smooth - could see this regulation spur more rigorous sustainability-related practices. Improving the sustainability performance of a company would not exclude it from any conventional funds but could facilitate greater access to funds with higher ESG expectations in its mandate.

More companies doing well on decarbonisation, human rights and biodiversity action means more eligible companies for sustainable indices and funds.

Both the pessimistic and optimistic narratives could increase diversity for a given portfolio. It depends on each fund's mandate and investment thesis.

Investors have a role to play. By engaging with policy makers and companies, investors can encourage enhancement of sustainability-related performance. Having desirable assets in the relevant sustainable index means a portfolio manager can deliver on their strategy, while minimising deviation from the benchmark, making it easier to articulate the choices of both index and investments to clients, boards, and regulators.

Conclusion

In a period of greater polarisation around sustainability, we see – yes – some wavering in commitments to objectives, though we see many investors hold strong and large volumes of real money still putting sustainability-related criteria into their mandates. It's going to be a bumpy ride. Drawing conclusions from the dynamics at play in global politics, as well as the corporate, academic and media domains is as complicated as ever.

With $168bn of passive assets tracking the EU's Paris-aligned benchmarks and Climate Transition Benchmarks as of November 2024,[7] there is money flowing to a select set of investments. Per the optimistic case above, the more we can enhance sustainability profiles, the greater the number of eligible assets and by association, diversity.

Investors can support sustainability objectives and increase diversity of portfolios by advocating for a strong policy environment that sets a clear direction of travel and provides the confidence needed to invest and innovate.[8] Investors can also engage with issuers, so they understand what qualities underpin eligibility for relevant indices and specific sustainable funds. Underwriting banks can help with this. Together, these moving parts can champion a market that promotes sustainability objectives alongside resilient returns in a way that is fair, clear and not misleading.

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[7] Morningstar, November 2024. *Investing in Times of Climate Change Report*
[8] CFA Institute, November 2024. *A New Focus for Investor Climate Commitments*

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