FEDERATION OF THE DUTCH PENSION FUNDS

POSITION PAPER

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SUBJECT: Sustainable Finance Disclosure Regulation

Fundamental SFDR review needed to make framework fit for pension funds

1. Introduction

The Dutch pension fund sector invests with the objective of providing participants a good pension in a livable world. As long-term investors, they need to take account of long-term sustainability risks that affect their portfolios. Moreover, many participants expect their pension funds to take into account the impact of investments on the environment and society at large. Europe needs huge private investments to achieve the net-zero economy by 2050. Therefore, we continue to support the objectives of the SFDR: providing transparency on sustainability in financial markets and boosting the financing of the transition to a more sustainable economy. We applaud the European Commission for engaging in an in-depth review in order to make sure that the framework achieves these goals more effectively.

The sector's focus on sustainability is visible when looking at the implementation of the SFDR by Dutch pension funds, with 93% of participants being enrolled in an Article 8 pension fund and 80% with a pension fund that opts into Article 4[1]. These pension funds have published precontractual information on their websites and have prepared their first principal adverse impact (PAI) statements. The figures stem from 2022 and, speaking to our members, we expect the number of pension funds reporting under Article 4 to increase now that the sector has gathered experience with PAI reporting.

With around 1500 billion euros of assets under management, the Dutch pension fund sector is a significant international institutional investor. The sector collaborates with related and external asset managers, fiduciary managers and data providers. Pension funds are at the end of the investment chain and therefore strongly rely on the aforementioned actors. At the same time, they have to provide information to participants. They are therefore both users and providers of information under the SFDR.

With this paper, the Dutch Federation of Pension Funds wants to share its considerations for the review of SFDR Level 1. It is clear that a **significant revision of the SFDR is necessary**, even if this would entail a considerable implementation effort.

[1] Source: AFM, November 2022, link. Note that no Dutch pension fund has more than 500 employees and PAI-reporting therefore is voluntary.

Several stakeholders have put forward proposals for improvements[2]. While helpful contributions to the debate, the focus in these submission lies on retail investment funds. In the current horizontal approach, the impact on all financial market participants must be considered. The specificities of pension funds need to be taken into account.

2. Problems embedded in the design of the SFDR

The current SFDR Level 1 framework shows multiple serious problems:

- The SFDR functions both as a disclosure tool and a label.
- Important concepts, most notably "sustainable investments" are not defined with sufficient clarity
- The horizontal approach leads to sub-optimal communication and implementation challenges.
- By focusing on what's already "green", the SFDR and Taxonomy do not stimulate the transition.
- Data availability and quality issues persist.

The SFDR functions both as a disclosure tool and a label

The SFDR was intended as a disclosure tool, aimed at tackling a principal-agent problem with additional information for investors. In particular, Article 8 requires the disclosure of the methods *how* characteristics are met, but does not lay down a minimum level of ambition.

The objective was arguably fraught from the beginning, as insights from behavioral economics show that more information does not automatically lead to better understanding and decision-making. Instead, the classification under Article 8 and 9 functions as a *de facto* label. The Dutch supervisor AFM has therefore argued that the classification as Article 8 or Article 9 should correspond with the actual sustainability characteristics of the product. Where this is not the case, the financial market participant could be considered to engage in greenwashing. Moreover, even the legal text of Article 8 inserts a minimum requirement on good governance and therefore even *de jure* includes both the labeling and the disclosure objective.

In order to solve this problem, disclosure and labelling should be disentangled in a manner such that it is clear to all stakeholders which information serves which purpose: supervisors, professional investors, retail investors and pension fund participants.

Important concepts are not defined with sufficient clarity

The fact that the SFDR functions as a label, is exacerbated by the fact that central concepts are not defined clearly enough, most notably "sustainable investments". Under a pure disclosure framework this could still work, as it is up to the reader to make a judgement of the financial market participant's (FMP) approach to sustainable investments. However, the European Supervisory Authorities (ESAs) have decided to make the proportion of sustainable investments a central metric in the Article 8 product disclosures and the reporting is intended to be comparable. The latter is currently not the case.

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[2] See for example the proposal of the French supervisor AMF (link)

The SFDR should create a common dictionary that actors through the investment chain can use to discuss the sustainability aspects of investment. In the case of the PAIs, with the caveat of data availability issues, this works relatively well. However, in the case of "sustainable investments" there is a common dictionary, but the words have different definitions for different actors. This increases the risk of purposeful or inadvertent greenwashing.

The horizontal approach leads to sub-optimal communication and implementation challenges
The horizontal approach of the SFDR has caused several challenges for pension funds. Both the legislators and the ESAs believed that cross-sectoral comparability is a key feature of the framework, but both Level 1 and Level 2 were developed with mainly retail investment funds in mind. Dutch pension funds are different for these reasons:

<u>Participants have no choice.</u> Participants are enrolled with Dutch pension funds because of their job. Signing the employment contract means enrolling in the fund. They cannot choose the pension fund and most often there is a single investment policy without options. SFDR information therefore is not actionable. This means that a pension fund participant engages in a fundamentally different manner with information than a retail client who is choosing a product to invest in. As a consequence, information provided to mandatorily enrolled participants needs to be simpler and more layered than information for retail clients or professional clients. The information provided under Article 8 is much too complicated and deters – rather than engages – participants looking to find out more about the sustainability aspects of their pension funds. Finally, there is no precontractual phase. Precontractual documentation is provided after joining the pension fund, so in fact it does not really serve a purpose in the customer journey.

<u>All types of assets in a single product</u>. While many retail products target a single asset class, pension funds invest in a myriad of asset classes within a single "product": government bonds, listed and private equity, corporate debt, private debt, securitizations, infrastructure and real estate. This leads to implementation challenges under the current SFDR. For example, it is proving hard to aggregate the PAI disclosures provided by external managers for investment mandates. It also challenging to operate the good governance test required under Article 8 for such a broad portfolio.

By focusing on what is already "green", the SFDR and Taxonomy do not incentivize transition
The focus of the current disclosure framework is to identify and measure sustainable economic activities. Agreeing on common definitions of what is sustainable was an important first step. The Taxonomy in particular set the bar high. Currently, only a small share of the economy qualifies. While capital investments towards Taxonomy-alignment of activities can qualify, this too will remain a modest share for the near future. The framework therefore currently does not sufficiently incentivize investments in the transition of the economy away from polluting technologies.

Pension funds will need to maintain diversified portfolios, as required by the prudent person rule in IORP2. This means that our members cannot only invest in Taxonomy-aligned activities or sustainable investments as defined by the SFDR. Therefore, they are keen to play a role in the broader transition through investments and engagement.

Data availability and quality issues persist
The EU did not follow a logical order when introducing reporting requirements for the financial sector and wider economy. The SFDR created reporting requirements for FMPs,

without the CSRD in place. This has meant that legal requirements were introduced which were nearly impossible to comply with. Data quality provided by investee companies, data providers and FMPs upstream in the investment chain still strongly diverges across indicators and jurisdictions. While data availability and quality may improve over the next year, we believe it is a matter of principle that entities should be only subjected to requirements they are able to comply with.

3. The desired design of the SFDR

We advocate a thorough review of the SFDR. Central features of the SFDR need to be changed in order to boost transition finance, achieve more tailored information for different types of users and reduce the risk of inadvertent greenwashing. This review should:

- Remove Article 8 and 9.
- Introduce voluntarily categories/labels.
- Introduce minimum requirements for all products, with proportionality.
- Let go of the horizontal approach.
- Consider the interplay between the SFDR and other legislation.
- Ensure compatibility with the CSRD.

Remove Article 8 and 9

It is widely acknowledged that the product disclosures in the SFDR have not had their intended effect. We do not believe that tinkering with Article 8 and 9, or introducing categorization next to Article 8 or 9, will solve the unintended consequences. Adding categorization next to Article 8 and 9 would significantly increase the complexity from the perspective of a pension fund participant or retail client. It will give more, rather than less, room for providers to present disclosures disingenuously in order to generate more sales. On the other hand, it will increase the likelihood of accidental greenwashing by pension funds trying to navigate the additional complexities.

Attempting to “improve” Article 8 and 9 by adding minimum requirements would also give rise to problems for pension funds. For example, the French supervisor AMF has proposed to impose quantitative thresholds for Taxonomy-aligned assets or yet-to-be-defined “transition assets”. In case these assets can mainly be found in the listed equity space, a given target for a pension fund with e.g. 25% allocation towards listed equity would be four times as ambitious as the same target for an equity ETF. This difference could also occur within the pension sector, where a pension fund with an older population is automatically more invested in government bonds compared to a relatively new pension fund with a young population.

The same challenge exists when taking into consideration the degree to which the ESG policy is “binding”. It is proposed that this is measured by considering the minimum reduction of the investment universe. This approach is also very much focused on the listed equity space. For asset classes like private equity, real estate, private debt, mortgages, securitizations and hedge funds there is no known universe from which titles can be excluded.

Given the current broad definition of promotion as provided by the European Commission in its Q&A, many pension funds would find it very difficult to reclassify their pension scheme from Article 8 down to Article 6. This would limit the ability to communicate with participants about sustainability. Adding inconsiderate retail-focused requirements to Article 8 could leave pension funds stuck between a rock and a hard place, having to balance sustainability and diversification considerations.

Introduce voluntary categories/labels

In order to meet retail demand for easy-to-understand information about sustainability characteristics of financial products, the EU should introduce categories or labels. These can be introduced through the SFDR or a separate legislative tool. It is important, however, that these categories are truly voluntarily. This means that the use of the categories should not be triggered by the content of product disclosures on sustainability or general communication on sustainability through the website, as is currently the case with “promotion”.

Introduce certain minimum requirements for all products, with proportionality

While disclosure requirements have not been successful at increasing the awareness of participants, a minimum level of disclosure on sustainability does serve a broader set of stakeholders. The fact that FMPs would be allowed to communicate about sustainability without using disclosure categories, should be mirrored with certain minimum requirements for all products. These could include a number of simplified disclosures from Article 8, such as the content of the sustainability characteristics, the ESG indicators used, as well as the engagement policy.

It should also be considered whether a minimum number of most relevant PAIs need to be reported at product level. However, it will be necessary to avoid a disproportionate impact. Reporting on Taxonomy-alignment and PAIs still requires to make use of external data providers. These costs are not insignificant for smaller pension funds, which spread the cost over a much smaller population of participants. We recommend incorporating proportionality, as is currently already the case with the employee threshold in Article 4.

Let go of the horizontal approach

The majority of pension fund assets in Europe are managed by not-for-profit institutions, managed by the social partners with mandatorily enrolled participants, with a significant allocation to government bonds for a more stable portfolio. These “products” do not need to be 100% comparable with listed equity mutual funds provided by for profit multinational corporations.

The need to cater to all potential information users has led to disclosures that are not suitable for most. The product templates are certainly too complicated for participants, whom are more likely to disengage than to engage with the pension fund on its responsible investment policy as the result of SFDR information. The templates reinforce the idea that information provided by the pension fund is too complicated and cannot be acted upon. Moreover, the entire precontractual phase is absent for Dutch participants so it does not make sense to provide precontractual information. Finally, quantitative targets are not comparable between different types of portfolios.

We are convinced sustainability disclosures could be better tailored if they were differentiated between different products and entities. This can be achieved by regulating sectorally at level 1 rather than horizontally. Both entity and products requirements could become part of IORP2 for pension funds. This would facilitate a more nuanced discussion within the context of what is achievable, appropriate and practical for each separate sector.

As an alternative, it is conceivable to maintain the SFDR but introduce separate articles in Level 1 and Level 2 mandates for different sectors. The current Level 2 measures are the product of discussions between ESMA, EIOPA and EBA. If EIOPA would be allowed to lead on an IORP-specific Regulatory Technical Standard, this would likely lead to more appropriate rules.

Finally, it could be conceivable to report or have targets at the level of asset classes. As mentioned, the fact that pension funds have much more complex portfolios leads to challenges. This includes challenges to aggregation of reporting, but also the fact that targets or “scores” might not be relevant for all asset classes within the product. The fact that a large share of assets are invested in government bonds, may blur the significance of positive or negatively sustainability characteristics in company-related investments.

Consider the interplay between the SFDR and other legislation

In our recent consultation response on the IORP2 Directive, we voiced our concerns that an adaptation of the prudent person rule would lead to an automatic classification of IORPs as Article 8. After all, in the SFDR Q&As, the ESAs have clarified that disclosures based on sustainability requirements laid down in law can also give rise to “promotion”. Similarly, we were also concerned that the adaptation would lead to the loss of the opt-out under Article 4. In its recent advice on IORP2, EIOPA has indicated that it believes the proposed adaptation of the prudent person rule will not automatically lead to the classifications as described. We welcome this statement but urge the European Commission to carefully consider this interplay to make sure it arrives at the same conclusion, before amending the IORP2 Directive.

Moreover, there is a lot of legislation relating to sustainability and the framework changes continuously. At the time of publication, it seems the financial sector will not be included in the Corporate Sustainability Due Diligence Directive (CSDDD) as far as investments are concerned. However, the proposal could have made the consideration of adverse impacts mandatory to some extent for the financial sector, with potential ramification on the opt-out under Article 4. And importantly the SFDR RTS state in recital 10 that: “one way in which financial products can promote environmental or social characteristics is to take into account principal adverse impacts of investment decisions”. The CSDDD could therefore have had implications for the classification as Article 8 under the current framework.[3]

Therefore, urge the European Commission to carefully consider the interplay between the SFDR and other pieces of regulation. Otherwise, financial market participants may face unintended consequences and supervisors will have to deal with inconsistencies when overseeing implementation.

Ensure compatibility with the CSRD

The European Commission recently adopted the European Sustainability Reporting Standards. The level of ambition was lowered in the final text and several recommendations of EFRAG were ignored. The Dutch Federation of deplores the fact that that it will not become mandatory for companies to report on PAIs, as they may indicate that the indicators are considered not material without explanation. However, pension funds formally still will need to report the PAIs for all investee companies under the SFDR. We strongly feel the European Commission should ensure full compatibility between the CSRD and SFDR by taking action at either Level 1 or Level 2 to address the current mismatch.

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[3] Note that this is particularly true for pension funds that only run one pension scheme, in which case entity and product are almost the same. On the other hands, FMPs offering many products can argue that entity-level disclosures under Article 4 do not have implications under Article 8.

On behalf of 156 pension funds, the Federation of the Dutch Pension Funds (Pensioenfederatie) promotes the pension interests of 6.2 million participants, 3.8 million pensioners and 9.1 deferred participants. About 85% of Dutch employees is participant of a pension fund which is associated with the Pensioenfederatie. The members of the Federation have around 1400 billion euros of assets under management.

APG, PGGM and MN provide asset management and pension administration services for Dutch pension funds. They are wholly-owned by pension funds or social partners.