POSITION PAPER

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SUBJECT: SFDR REVIEW

1. Introduction

Last year three relevant documents were published which aim to inform the policy debate on the review of the SFDR. An Assessment requested by the ECON Committee[1] and two Opinions, one of the joint ESAs[2] and another of ESMA.[3] All three publications recognize the SFDR for being a major step forward. Yet, they also urgently convey that the SFDR is too complicated and does not work as intended.

In December 2023 the Dutch Federation of Pension Funds shared its own considerations on the review of the SFDR.[4] These were submitted in response to a consultation of the Commission.

Summary of the response to the SFDR Consultation by the Dutch pension sector

Main problems of the current SFDR:

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

Solutions to improve the SFDR:

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

[1] The current Implementation of the Sustainability-related Financial Disclosures Regulation (SFDR). Requested by the ECON Committee. July 2024.
[2] Joint ESAs Opinion. On the assessment of the Sustainable Finance Disclosure Regulation (SFDR). June 2024.
[3] ESMA Opinion. Sustainable investments: Facilitating the investor journey. A holistic vision for the long term. July 2024.
[4] Fundamental SFDR review needed to make framework fit for pension funds. Dutch Federation of Pension Funds. December 2023.

Dutch pension funds believe that private finance can play a major role in the transition to a sustainable economy. We also see the importance of providing transparency on the sustainability aspects of pension funds' portfolios. This becomes evident in the way the SFDR was implemented so far:

- 65% of Dutch pension schemes are Article 8 products, representing 96% of active (i.e. employed) participants in the Netherlands[5].
- 41% of Dutch pension funds report voluntarily[6] on principle adverse impacts, representing a significant majority[7] of active participants.

Despite the support, we believe that the current set-up of the SFDR does not work well for pension funds. Therefore, we welcome the proposals for a fundamental review.

The present paper seeks to contribute to the debate by analyzing the key issues and proposals raised in the aforementioned publications, in particular the ESAs Opinion, from the perspective of pension funds. Our **main issue** is that the focus of policymakers thus far has been on finding solutions that work for retail investment funds. This means that some design features of the SFDR are less-suited for broadly diversified institutional investors, such as pension funds. Dutch pension funds mostly operate only one pension scheme, with a very large and complex portfolio. Pension schemes have a long-term objective and their investment strategies rely on a broad diversification, covering many asset classes. These elements give IORPs a unique position.

We therefore welcome the reflections of the ESAs Opinion and the other publications on the way the current SFDR rules work out for pension funds and insurance companies. Yet, their proposals do not address essential differences between pension funds and investment funds, most notably the automatic or mandatory enrolment process.

Key points in response to ESA Opinion:

- Recognition of the relevance of non-category products is fundamental
- The transition and impact categories could improve congruency with market reality, but design features will be crucial
- Indicators may be methodically challenging for consumers and participants
- A better definition of "sustainable investments" is important
- Shareholder engagement needs to be recognised as a valid method of attaining sustainability objectives
- Remove government bonds from relevant ratios, in absence of a specific framework
- Consider interplay with Omnibus Simplification Package and L2 Review

[5] Source: AFM, 2024 (link).

[6] All Dutch pension funds (but one) have fewer than 500 employees and therefore may opt-out of PAI reporting.

[7] In 2022, the AFM found that 31% of Dutch pension schemes reported PAIs. At the time, that represented "more than 80%" of active participants. Given the increase of the number of schemes that report PAIs to 41%, the number of participants who are enrolled in a pension fund that reports PAIs today must be significantly higher.

2. Reflections on the ESAs Opinion from the pension fund perspective

Recognition of the relevance of non-category products is fundamental

We welcome the effort to design a transition category that is accessible to pension funds. However, the operationalization into criteria **could nonetheless result in a situation in which, in practice, pension funds will not be able to use these**. The reason for this is that it is very challenging to define meaningful criteria for all types of products under the horizontal approach. Pension funds are subject to the prudent person rule in IORP2[8], which requires pension funds to hold a diversified and stable portfolio, in consideration of the duration of liabilities and (interest rate) risks on behalf of participants. Pension funds cannot limit their investment universe to the narrow subset of the economy that is, for example, Taxonomy-aligned. They are required to mitigate interest rates by allocating a significant part of their portfolio to government bonds. Pension funds are also different in that they typically offer only a single product – the pension scheme. In comparison, the product offering of investment fund providers splits such a portfolio in different products. Positive sustainability characteristics are more easily identified in asset classes with broad ESG data coverage, such as listed equity, and therefore "diluted" in complex and hedged portfolios. If a transition category would set sustainability targets that remain ambitious for investment funds, the targets could lead to a portfolio at odds with the prudent person rule for pension funds.

In case Dutch pension funds would not have access to the transition category, they still want to be able to communicate about their (responsible) investment policies towards their participants. Therefore, it is vital to consider the communication rules for this group of FMPs and non-category products. Under the current SFDR, FMPs are limited in their ability to communicate about sustainability characteristics of non-sustainable products (Article 6 products), because it is the communication that essentially triggers the classification as Article 8. This has led to some cases "green hushing". Such an outcome should be avoided.

We therefore believe it is right that non-category financial products could be subjected to some additional disclosures, subject to a proportionality assessment by the European Commission. Simultaneously, **these FMPs should not be banned from communicating about the sustainability characteristics**. The Opinion notes that it is necessary to avoid inflated claims through marketing and product names. We agree with this statement, but note that this would require a strict and airtight definition of what constitutes "marketing". In The Netherlands, pension funds operate on a not-for-profit basis and employees are mandatorily enrolled. In our view, Dutch pension funds therefore do not engage in marketing. Moreover, Dutch pension law already requires all information, including information about sustainability to be accurate, substantiated and understandable. The Dutch supervisor has issued guidance how the law applies to sustainability information.

[8] Article 19 on Investment Rules.

Relevance and design of the transition category for pension funds

As mentioned in our consultation response, we welcome the idea to introduce categories, as long as these are truly voluntary and FMPs are still allowed to communicate about the sustainability characteristics of products without a category. A **transition category should help to gear the SFDR towards broadly diversified institutional investors**, such as pension funds and insurance companies. Taking a long-term responsible investment approach, many Dutch pension funds invest in companies and projects that contribute to the shift towards a sustainable and low-carbon society. The transition category could therefore serve as a vehicle for their sustainability policies, thus enabling them to support the transition from a long-term, institutional perspective.

However, the design of a transition category that is ambitious and meaningful yet achievable for a diverse group of FMPs is a challenging task, as mentioned. For that reason, we propose that FMPs (including pension funds) should be **allowed to decide upon the method of categorization**, either by:

(i) total product, or
(ii) underlying products of their portfolio and communicate on the various percentages (based upon categorizations of external asset managers or upon the pension funds own assessment).

Pension funds mostly outsource their asset management and they invest through mandates or investment funds, which are considered products under the SFDR. As such, asset managers, operating on a product scale, could be able to meet the categorization requirements, thus benefitting from the categorization system. Pension funds should be able to benefit too for the same portfolio at the aggregate level. This would look as follows:

Categorization method	
☐ Total product	☐ Transition; or ☐ Sustainable; or ☐ No category.
☒ Underlying products	Transition: 20 % Sustainable:10 % No category: 70 %

We believe that this would add to the ambition to improve the disclosures to be less complex, thus empowering pension participants, just like retail investors, to better understand the underlying sustainability profile of their pension scheme.

In order to make it feasible for pension funds to use this categorization, the following further considerations are important:

- As acknowledged by the ESAs in their discussion on government bonds, we believe **transition pathways should not apply to government bonds**. The same applies

to other assets held for hedging and liquidity purposes, such as financial derivatives (interest rate swaps) and money market funds. These assets should be removed from the denominator, in case ratio thresholds would apply for the category. It would be necessary to consider how assets would be treated for which data availability is challenging. This particularly applies to private asset classes.

- Transition pathways are currently mainly established for climate and the Opinion puts emphasis on using the Taxonomy. Both for credibility and applicability, it is **necessary to use science-based targets**. Once a social Taxonomy will be developed it will be possible to expand the scope of transition beyond the transition to a carbon neutral economy. In general, the SFDR should lay down strict rules on how progress against objectives is measured, what the role of transition plans is, and put in place quantitative targets over time. This helps to ensure that the use of the transition category in disclosures is trustworthy for both pension fund participants and retail investors.
- The **relationship between the transition category and the EU climate benchmarks** should be clarified, as these are specifically defined as "transition finance" in the European Commission recommendation on transition finance[9].

Impact category

We would also welcome the possibility to categorize a small subsection of the total assets under management as "impact". For reasons that were already explained, an impact category – even when excluding government bonds – seems unfeasible for the portfolio of a pension scheme at the aggregate level. The cross-cutting impact indicator should not apply to non-category products.

We note the discussion of **"investor impact" versus "company impact"**. However, in our experience, it is nearly impossible to irrefutably prove what role the investor has played in achieving certain outcomes. We also note that the Global Impact Investing Network does not require proof of investor additionality in its definition of impact investing. Too strict an approach could potentially render the entire category useless.

Indicators may be methodologically challenging for consumers and participants

Indicators can be very powerful as a tool, as they provide a simple and understandable summary of the topics they cover. However, we also recognize the methodological challenges highlighted by the European Supervisory Authorities (ESAs), the ESMA Opinion, and the ECON Assessment. Therefore, we urge caution in using indicators, primarily because they risk overshadowing other disclosures while failing to fully capture the complexity of the ESG spectrum.

Specifically, we have the following considerations:

1. Complexity for Retail Investors and Pension Fund Participants: Introducing both categories and indicators would add a significant layer of complexity for retail

[9] Commission Communication COM(2023) 317, "A sustainable finance framework that works on the ground"

investors and pension fund participants. We anticipate that retail investors and participants will be most influenced by the simplest tool, which is the indicator. Many individuals may not invest the effort to understand the complex interlinkage between an indicator and the categories.

2. Scope of Responsible Investment Efforts: While an indicator based on financed emissions or the Taxonomy would be grounded in comparable and objective information, it may inadvertently limit the scope of efforts across the entire spectrum of responsible investments towards climate change. This is a clear downside of the strong communicative power of a simplified indicator, which we think is an undesirable incentive.

3. Applicability for Pension Funds: Whether pension funds can realistically use the transition category will depend on the final design and criteria. Designing a category that applies to different types of investors (e.g., simple equity-only UCITS and pension funds) will be challenging. It is therefore possible that product categories remain out of scope for pension funds. This could result in pension funds automatically falling within the lower score range of the indicator.

Therefore, we urge to explore options that consider the characteristics we have previously explained. An indicator might be more methodologically feasible and compelling when it applies to a subset of assets under management. Furthermore, making indicators voluntary might limit the impact of unforeseen second-order effects. We find that cross-cutting indicators are especially undesirable at a time when there is consensus that many European countries would benefit from expanding the occupational pension system to ensure fiscal sustainability as societies age.

A better definition of "sustainable investment" remains important

We share the view of the Opinion that it is essential to work on a good definition of "sustainable investment" and in particular to pay attention to the, now very complex and hermetic, relationship between the SFDR and the Taxonomy. In this context, we find recitals 42 and 43 of the Opinion illuminating, in which an attempt has been made to arrive at an interpretation of the coherence. However, while it is useful to align the definitions, we note that our participants see sustainable investments as a much broader concept than just Taxonomy-alignment. Having a too limited definition would therefore not lead to a better understanding by end-users.

Shareholder engagement needs to be recognized

Dutch pension funds are active shareholders. Most pension funds have engagement and active voting policies. Many participate in investors coalitions such as the Institutional Investors Group on Climate Change (IIGCC). While we have seen many of the large Dutch pension funds divest from fossil fuel producers after unsatisfactory engagement trajectories, they continue to engage with companies on other issues. We also believe that divestment and engagement go hand in hand. If all socially responsible investors divest, only indifferent shareholders remain. On the other hand, the threat of actually divesting has to be credible in order for engagement to have impact.

The **ESAs Opinion essentially disregards engagement as a tool for obtaining sustainability objectives**. We believe this would be a missed opportunity, as Dutch pension funds deem engagement to be an essential part of the toolkit. The disregard may stem, in part, from the fact that engagement often occurs at entity level. However, in the case of pension funds, the product and entity level are the same. We welcome the ESMA Opinion, which states that the SFDR should fully support the concept of active engagement and we urge the European Commission to consider how engagement can be made relevant in the context of the SFDR, for example as a tool for meeting transition pathways for the transition category. However, we note that the existing disclosures, for example in the PAI statement, already provide information on this topic and additional administrative burdens should be avoided.

Remove government bonds from relevant ratios, in absence of specific framework
As borne out by the discussion on comparability above, the fact that pension funds invest significantly in government bonds leads to issues in the context of the SFDR. At the moment, a significant part of the portfolio is considered "grey", meaning not contributing to sustainability objectives.

It should be considered whether the portfolio should be split between assets held for hedging and treasury purposes on the hand and other assets on the other. This would mean that **government bonds would essentially be removed from both the nominator and denominator of relevant ratios**, for example for meeting the criteria of a transition category or for the calculation of sustainable investments. The same would apply to interest rate derivatives and investments in other types of money market instrument.

Consider interplay with Omnibus Simplification Package and L2 Review
FMPs rely on corporate data in order to meet the reporting requirements of the SFDR. While the SFDR is already in effect for a number of years now, corporate reporting is only being rolled out under the CSRD/ESRS. Moreover, the European Commission may soon intervene in this process through the so-called Omnibus initiative. If this initiative would lead to a further delay or material amendments to the content of the reporting requirements, these changes should be considered in the SFDR review. The level of ambition and regulation should not start to diverge.

Moreover, the ESAs have put forward amendments to the SFDR RTS in December 2023. Thes have not yet been adopted by the European Commission. We urge the Commission to consider the impact of running L1 and L2 concurrently.

Reflections on the ESAs Opinion from participant's perspective

The current disclosures under the SFDR are very complex and legalistic. They make little sense to the average consumer. We therefore strongly support the ESA recommendation that any review of the SFDR should be tailored to the specific needs and characteristics of the end-users. However, we emphasize that pension fund participants have a fundamentally different customer journey than retail investors. The automatic enrolment (without opt-out) means that they have no ability to act on the information

they receive. Our participants will not be comparing pension schemes as part of their customer journey. And even if they would be able to do so, it is debatable whether there is an objective way to compare different financial products or even different pension schemes[10]. Therefore, we strongly recommend that any revision of the SFDR, whilst serving the same purpose, takes these differences and their consequences into consideration. This could imply letting go of the horizontal approach and tailoring rules to specific types of FMPs, both in Level 1 and through separate L2 mandates.

What would this look like for pension funds? As a consequence of their automatic or mandatory enrolment, participants are less inclined to read pages of complex information. This does not mean they are not entitled to good-quality information about the sustainability characteristics of their pension funds' investments. Yet, this information should be understandable and pension funds should be able to tailor their communication to the characteristics of their participants. To make this more explicit, the texts that result from the revised SFDR requirements should be readable for participants with different levels of education and different language and reading skills[11].

With regard to the Regulatory Technical Standards, this could include the following:

- Chapter 2, Section 1: We recommend the translation of the concepts 'principle adverse indicators' and 'sustainability factors' into accessible language that is understandable for pension fund participants. We further suggest the development of an introductory text that can be published along with the PAI statement, with explains the purpose of reporting on the PAI's.
- Chapter 3: Since pension funds with automatic or mandatory enrolment do not have a precontractual phase, the required disclosures in this chapter are not applicable. This means that products with a mandatory enrolment phase should not be required to provide precontractual disclosures. As an alternative, new participants of a pension fund could be informed about the sustainability characteristics of the pension fund through periodic disclosures.
- Chapter 4, article 24b, c and f and article 37b, c and f, and Chapter 5: We expect that the concepts of 'promotion of environmental or social characteristics' and 'sustainable investment as objective' will be subject to revision and translated into categories. From the perspective of participants, this is advisable because it is hard

[10] Consider the example of comparing a "young" scheme with mostly active (employed) participants with an "old" scheme with mainly retirees. Let us assume the young scheme has a simplified portfolio of 90% listed equity and corporate debt, and only 10% government bonds. The old scheme has derisked mostly by investing 90% in government bonds. The young scheme just follows the index and achieves 2% of Taxonomy-alignment in equity and corporate debt, meaning 1,8% at portfolio level. The old fund has an ambitious impact strategy and targets 10% taxonomy-alignment in company investments, leading to 1% Taxonomy-alignment at portfolio level. From the SFDR-objective of consumer protection, it is more precise to say the young fund is more sustainable. From the SFDR-objective of increasing the financing of sustainable activities, the old fund is more sustainable.

[11] Please note that the Dutch Federation of Pension Funds drafted a document 'Switching to Green Language' which intends to inspire Dutch pension funds to replace 'difficult' concepts that are often used in the financial sector into text that is accessible for their participants.

(if not impossible) to grasp the logic and boundaries of the aforementioned concepts. In their communication with participants about any new categories, including the non-category products, pension funds should be able explain how their long-term investment decisions and sustainability considerations interrelate. We reiterate that in our view this is not marketing, but part of the fiduciary duty towards participants with mandatory or automatic enrolment.

- Finally, we recommend that any revision of the SFDR should be subjected to testing by all relevant users, which is also propagated in both the ESMA Opinion and the ECON Assessment[12]. If the revised SFDR continues to include pension funds, this implies that testing needs to include pension fund participants with automatic or mandatory enrolment.

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 1500 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.

[12] The ECON Assessment acknowledges the different informational needs of professional investors. And the ESMA opinion aims to cover the whole Sustainable Investment Value Chain in its policy recommendations. Further, ESMA proposes that next to consumer testing industry testing should take place to test feasibility and workability of solutions by FMPs. This also includes pension funds as users of information.