Defined Contribution Investment Forum

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ESG 2.0 SERIES

What SDR means for UK DC pension schemes

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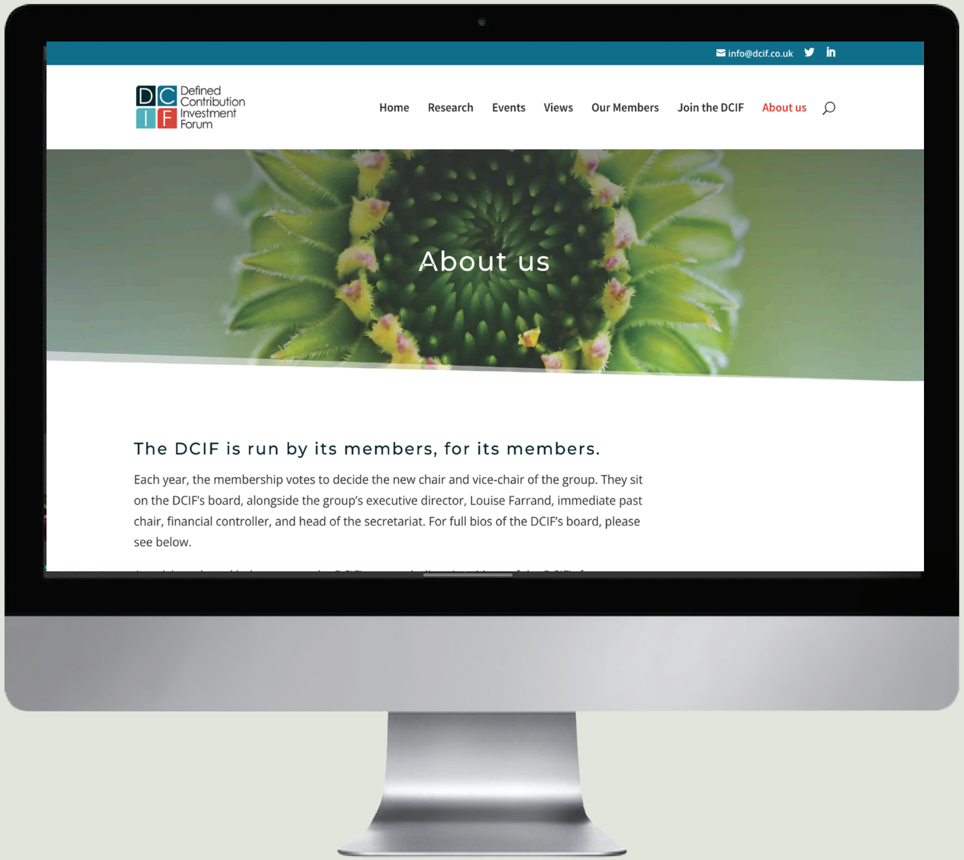


Who are we?

We're a group of asset managers who believe that a well-designed and diverse investment strategy has an important role in delivering a comfortable retirement for millions of DC savers.

A not-for-profit organisation, we commission and publish research which shines a spotlight on DC investment issues. We hope the people who determine DC pension schemes' investment strategies will use it to inform their work.

We also arrange events. From virtual roundtables to in person gatherings, they're a great way to learn more about DC investment issues and meet a like-minded community of trustees, pensions managers, investment consultants and more.

To find out more about our work and explore membership options, please visit: www.dcif.co.uk

Our members

Our members shape the DCIF's direction and steer research projects. They are:

- abrdn
- AXA Investment Managers
- Baillie Gifford
- CBRE Investment Management
- Nordea Asset Management
- Northern Trust
- Columbia Threadneedle Investments
- First Sentier Investors
- J.P.Morgan
- J.P.Morgan Asset Management
- nuveen
- PGIM Private Alternatives
- Janus Henderson Investors
- MFS
- Mobius Life
- Nareit
- Phoenix Corporate Investment Services
- Wellington Management

What are the Sustainability Disclosure Requirements (SDR)?

In the UK, the Financial Conduct Authority (FCA) is in the process of introducing Sustainability Disclosure Requirements (SDR), which introduces voluntary labels for sustainable funds as a key component. SDR follows on from similar regulations elsewhere in the world, such as the European Union's SFDR regulations.

SDR has introduced new investment product labels, for which sustainable funds can apply. Funds fall into three broad categories (see points one, two and three, immediate right).

Asset managers are implementing SDR at present, ahead of a December 2024 deadline for label applications. There was an earlier deadline of 31st July 2024 with limited uptake – but more managers are expected to apply for labels in time for the December deadline, as there has been preparatory work to do since the regulations were finalised. After December 2024, managers can apply for labels on a rolling basis.

Two fifths of asset managers with UK domiciled funds plan to apply a sustainability label to at least one of their funds, research by the Investment Association shows. The labels are there to ensure that every fund which makes sustainability claims can back them up with evidence.

1

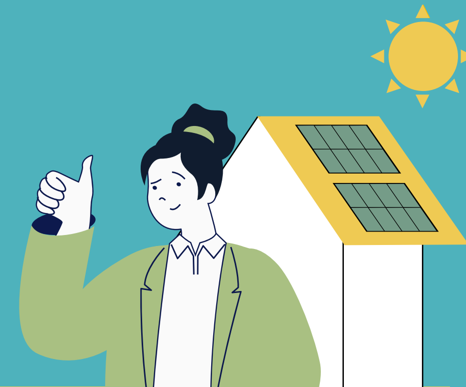
Sustainability-labelled funds have achieved one of the FCA's labels.

2

Non-labelled ESG funds use ESG terminology in their names or marketing, but do not have one of the FCA's sustainability labels.

3

Non-ESG funds are funds that make no ESG claims.



The origins of anti-greenwashing regulation

Of all the accusations that companies might face, greenwashing is one of the most mortal sins of the modern age. Greenwashing can take many forms, but broadly speaking it happens when companies make environmental claims that they cannot substantiate.

In the investment world, this translated into some asset managers exaggerating the sustainability features of their funds. Regulators are introducing legislation to combat greenwashing and help to arm anyone buying funds with robust information about their ESG credentials.

What do the labels mean?

1 **Sustainability Focus** products invest in assets that are environmentally or socially sustainable, determined by a robust, evidence-based standard of sustainability.

2 **Sustainability Improvers** invest in assets that have the potential to become more sustainable overtime, determined by their potential to meet a robust, evidence-based standard of sustainability overtime.

3 **Sustainability Impact** seek to achieve a predefined, positive, measurable environmental and/or social impact.

4 **Sustainability Mixed Goals** invest in assets that meet or have the potential to meet a robust, evidence-based standard for sustainability, and/or invest with an aim to achieve positive impact.

Source: SDR Explained, J.P. Morgan Asset Management

What do pension schemes need to know about SDR?

SDR is primarily aimed at retail investors. The intention is for the labels to give consumers confidence that the sustainable funds they are investing in live up to their name.

Will SDR be important for defined contribution (DC) pension schemes? Lorna Kennedy, a partner at Baillie Gifford, believes so. "If DC pension schemes are looking to add a sustainable fund, I think they will want the comfort of it having a label. And I think consultants will use the labels, because they will be well defined."

Siobhan Cleary, deputy head of ESG at Baillie Gifford adds: "Pension fund trustees should have a clear understanding what the four categories of label mean – because if they are looking to invest some of their assets into one of these categories, they should be evaluating whether the fund lives up to those expectations."

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Will DC pension schemes ever have to comply with SDR regulation?

Pete Cox, Northern Trust's head of ESG product, says: "SDR won't apply to UK pension schemes initially, but the FCA hasn't ruled it out. As a comparison, certain pension schemes in Europe do need to comply with SFDR. SDR could well hit the UK pensions space. It's a wait and see situation at the moment."

SDR is likely to eventually apply to pension schemes, predicts Alasdair Birrell, workplace investment proposition lead at Standard Life UK. "If you're a pension scheme, it's probably time to think about getting your house in order."

The first step is for trustees to understand and take an interest in the new requirements for asset managers, with the long-term view that this may eventually apply to them.

What are the differences between SDR and SFDR?

SDR has important distinctions from SFDR. Alexandra Melhuish, sustainable investing strategist at J.P. Morgan Asset Management, observes: "This is the first piece of financial legislation post Brexit where the UK is trying to use a second mover advantage."

Northern Trust's Pete Cox adds: "The FCA has learnt from observing other attempts at this type of regulation, such as the SFDR in Europe. They want to be as aligned as possible; they like the idea of regulatory convergence globally. Nobody wants a situation where there are multiple different requirements. But they definitely haven't gone down the same route as Europe, with very prescriptive fund classifications.

"In SDR, the UK has learnt not to be so prescriptive with explicit data point disclosures. It has put the onus on transparency by clearly explaining what you are doing, why you're doing it and what you are claiming the fund to be. It is a bit more open, to avoid the back and forth of updated label definitions and data points that go with them that has created a challenge for European participants."

Will SDR succeed in preventing greenwashing?

The DCIF's experts believe SDR is a helpful evolution from the EU's SFDR regulations. As we've already mentioned, it is less prescriptive than SFDR and more principles based. It sets a very high bar for funds, which means that only a select few will seek the labels. That said – just because a fund doesn't seek a label doesn't mean it is a 'bad' fund. Following many changes to the SFDR requirements, asset managers may well be waiting to see how SDR evolves in the UK market before applying for a label.

"We were doing a lot of this already," said one manager, "but I do think that the depth of these disclosures and requirements will help combat greenwashing and move the industry in the right direction. Because it's disclosing on sustainability, which we've never had to do before, and starting with such strict rules, and then adding rules around what you are allowed and not allowed to say about non labelled funds in marketing material, I think it should help to strip back some of the claims that funds are making today."

The existence of SDR and other, similar-but-different anti-greenwashing regulations across the world does create complexity, because managers need to comply with different sets of anti-greenwashing regulations.

FURTHER INFORMATION

The Investment Association's SDR Implementation Survey reports on the progress investment management firms have made, and their plans for the future. Read it here.

Consultants should keep pension schemes in the loop on SDR developments.

Pension schemes should also feel free to ask their asset managers for more info.