Effective Credit Risk Sharing

Key reforms to unlock the true potential of on-balance-sheet securitisation

We strongly support the initiatives to improve the competitiveness of EU financial markets and to develop a stronger and more robust Saving and Investments Union ("SIU"). We believe that securitisation can contribute to these objectives. By mobilising private, long-term oriented capital for the green and digital transitions, securitisation can advance a more sustainable financial system and add value to the real economy. To unlock its true potential and improve access for European institutional investors, it is crucial to simplify overly prescriptive regulation while maintaining and strengthening the foundation of high-quality standards.

In this paper we will explain this view by highlighting:

- why we invest in on-balance-sheet securitisation, which we refer to as 'Credit Risk Sharing' ("CRS")
- the size and features of the CRS market
- how CRS can contribute to the goals of the SIU, and
- what improvements to the functioning of the CRS market can be implemented to facilitate more issuance and to encourage participation of a broader range of institutional investors.

Executive summary

Credit Risk Sharing ("CRS"), also known as on-balance-sheet securitisation[1], is an efficient credit portfolio management instrument for banks. It functions as a hedge on the credit risk in banks loan portfolios and is typically structured to achieve regulatory capital relief. Through CRS, banks can free up capital and counterparty credit limits, which creates new lending capacity. By doing so, CRS can transfer capital from investors, through banks, towards the real economy. As such, CRS could play a key role in unlocking the financing required for the green and digital transitions.

PGGM is one of the most experienced and largest end-investor in CRS. Since the inception of our mandate in 2006 we have closed nearly 100 CRS transactions. Our high standards promote a sound and robust CRS market which can support the financial system in adverse times, such as the Global Financial Crisis (GFC), Covid-19 pandemic or inflationary pressures and geopolitical unrest. We have proven that by our continuous presence in the market for nearly two decades.

To date we have invested € 19 billion in the CRS market. As per end of December 2024, we have a portfolio of around € 7 billion which references close to € 80 billion of loans related to a diverse group of borrowers and loan types across the world. From an investor's perspective, CRS provides an opportunity to generate attractive total returns through unique credit exposures which are not available in public markets. As a pension fund asset manager, by our nature we have an investment horizon that stretches decades rather than years or months. Therefore, the long-term viability and sustainability of the CRS market is of the utmost importance to us, and we highly appreciate the efforts to develop the securitisation market in Europe. We believe that achieving the goals of the SIU can only be a success when the needs of the relevant market parties are in balance, including those of banks, regulators, and long-term oriented institutional investors such as pension funds. This means that for CRS to play a

[1]'On-balance-sheet' securitisation is also referred to as 'synthetic securitisation', 'Significant Risk Transfer' or 'SRT' and 'Capital Relief Transactions' or 'CRT.' For more details on this terminology, we invite you to visit our dedicated website.

constructive role in the financial system, it needs to function well while allowing efficient monitoring and supervision. This way, it can be a valuable instrument for issuers (banks) and an attractive investment for investors, adding to the stability of the financial sector as a whole. To achieve this, targeted adjustments to the current securitisation regulatory framework are required. These adjustments simplify the regulatory process for investors and issuers, while maintaining and strengthening the strong foundation Europe has built. In short: supporting high standards while minimising micromanagement. While currently we only invest in CRS, we believe that some of the below mentioned changes will stimulate the growth of the entire securitisation market.

First and foremost, three elements of the EU Securitisation Regulation ("SECR") should be improved, the first two focused on simplifying regulation while the third builds on high EU standards:

- *The investor due diligence requirements:* are overly prescriptive, as they require verification of information which is not always relevant. This increases cost and because of compliance risk discourages new investors from entering the market. The due diligence requirements should be principles-based, allowing investors to assess and decide what kind of due diligence is necessary for each investment. Investor should have access to high-quality data.
- *The transparency requirements:* demand investors to verify whether issuers have provided a set of detailed information in a prescriptive format of the ESMA templates. This detailed information is not fit-for-purpose for CRS transactions, and it is also different from the verifications under the due diligence process. The imposed disclosures are an impediment to growing the securitisation market. As such, the reporting templates need to be simplified as a matter of urgency.
- *The STS label for CRS transactions:* the high-quality nature of the STS designation should be improved by allowing more options for collateralisation, by removing counterparty risk for investors, and by requiring 20% risk alignment for first loss CRS transactions. There are some further technical changes which would benefit the label, which we set out in more detail below.

In addition to the above targeted adjustments to the SECR, some other suggestions to simplify regulation and improve of the efficiency of the securitisation framework are:

- A "fast track" (prudential) approval for established issuance programmes, which reduces the need to request regulatory approval for each new transaction.
- Streamlining of the STS verification regime by removing the requirement for investors to assess adherence to the STS criteria, as they do not directly benefit from the STS label.

Finally, in the final Basel 3 text the prudential treatment of securitisations, and in particular the senior tranches retained by banks in CRS transactions, is overly conservative. In this regard, it would be helpful if the transitional measures, which currently are reducing the p-factor for purposes of the output floor are made permanent or are replaced by a different appropriate capital treatment.

Securitisation issuance and structuring in Europe is predominantly driven by the regulatory framework. For this reason, we believe these suggested changes, which we describe in more detail below, can greatly improve the existing regulatory framework and stimulate the growth of a robust securitisation market with high-quality transactions which are suitable for pension fund investors, such as PGGM. Consequently, they will unlock securitisation's full potential to play a major role in financing Europe's transformation towards a more carbon-neutral economy and in achieving the SIU goals.

Introduction to PGGM and Credit Risk Sharing

PGGM has been investing in CRS since 2006, on behalf of our sole client, Stichting Pensioenfonds Zorg & Welzijn ("PFZW"), the € 259 billion pension fund for the Dutch care and healthcare sector. We typically invest in first loss tranches, sharing the credit risk with the originating bank. We refer to our investments as 'CRS' for 'credit risk sharing' or 'SRT' for 'sharing risk together' because we believe that this better reflects the nature of our transactions, which is a genuine sharing of credit risk between the bank and the investor.

We are recognised as one of the most experienced and largest active investors in this segment of the securitisation market. As per end of December 2024, we have a portfolio of around € 7 billion which references around € 80 billion of loans related to a diverse group of borrowers and loan types across the world. By engaging in CRS transactions PGGM and PFZW aim to partner with market-leading banks[2] and share in their credit risk exposures that come from long-standing core activities.

As a pension fund asset manager, we highly value the long-term stability and sustainability of the credit risk sharing market. For this market to grow the needs of banks, investors and regulators must be met in a healthy and balanced way. Therefore, since many years we have become a vocal advocate for harmonisation of practices, appropriate standards for healthy transactions and transparency. We hope that by helping to shape standards in this relatively young but rapidly developing and promising asset class, we can continue to build a robust and sustainable market in which risk is genuinely shared between the bank and investors.

Why and how we invest in Credit Risk Sharing

In CRS transactions, a bank buys credit protection on a portfolio of loans. As an investor in CRS, we typically take the first loss exposure to a selection of bank's core credit portfolio and reimburse that bank for credit losses. This is done synthetically, meaning the underlying loans are not transferred and remain on the bank's balance sheet. For that reason, CRS transactions are also called 'on-balance-sheet' or 'synthetic' securitisation.

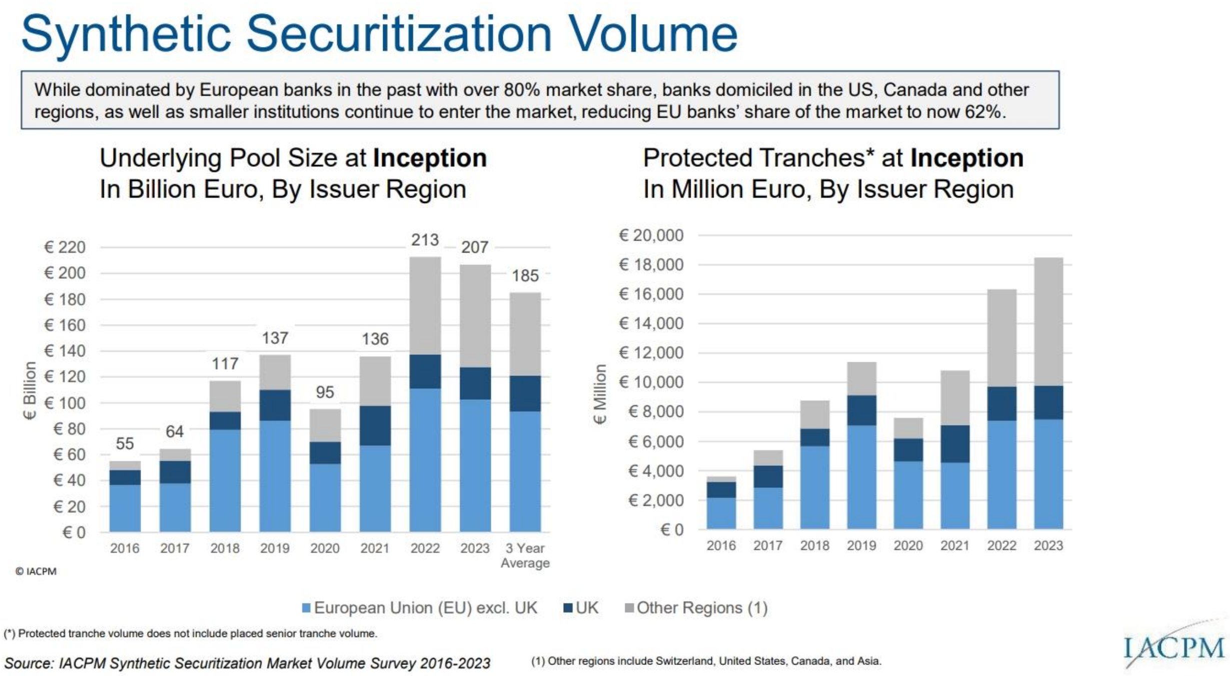
The benefits of our transactions are mutual: they provide us with an opportunity to work with experienced credit managers (banks) with 'skin in the game' and to generate attractive total returns through unique credit exposures not available in public markets. For banks, the transactions allow them to benefit from regulatory capital relief and to manage their (illiquid) credit exposures more efficiently and in a sound way, leading to less systemic risk and a more sustainable financial system. CRS transactions also help to finance the real economy and the green and digital transitions.

Our investment process focuses on obtaining an in-depth understanding of a bank's strategy, origination, and credit risk management processes, so there is a genuine sharing of risk between that bank and us as investor.

[2] Over the past 18 years we have built long-standing partnerships with strong transaction standards with more than 16 banks, in Europe and across the globe.

CRS market today

The market for CRS transactions has been growing steadily and substantially in recent years. According to the data collected by the International Association of Credit Portfolio Managers ("IACPM")[3], global issuance of CRS is at a level of € 18.5 billion, referencing over € 200 billion in underlying portfolio loan notional. EU banks are contributing to about half of that issuance. See the graph below. Please note that CRS transactions are mostly private arrangements thus, the data gathered by IACPM is on a voluntary basis and the issuance of CRS is likely higher given their private nature.



On the issuer side, there are both new banks entering the CRS market while banks with existing programs are expanding their issuance. On the investor side, a significantly increased appetite for CRS has been recently observed as well. The CRS market is steadily opening for the last couple of years. This reflects an increasing acceptance of CRS as an essential part of the capital and credit portfolio management toolbox by banks and regulators, and a greater interest of investors in the product.

As mentioned above, CRS transactions are usually private and bilateral in nature, meaning that they are concluded between the issuing bank and the investor and are not publicly traded. The investor is in a position to request all data required to assess the transaction.

Nearly two decades of our experience has shown that CRS has been resilient through various economic headwinds, including the GFC and the COVID-19 pandemic. This is evidenced by low losses throughout the many different transactions we have invested in to-date. The vast majority of transactions in our CRS portfolio are performing or have performed better than initially expected, and no transaction has come anywhere close to causing a loss to the senior tranche (retained by the originating bank). This is reflected in our performance figures, which show we have generated an average annual return of around 11% for our client, PFZW. Further detail is available on request.
Several analyses of the European CRS market since 2008, such as the comprehensive EBA Report on STS Framework for Synthetic Securitisation[4] (May 2020), also show very low loss rates in this segment

[3] Source: IACPM 'Synthetic Securitization Market Volume: 2016 – 2023' (link: PowerPoint Presentation (iacpm.org)).

[4] EBA Report on STS Framework for Synthetic Securitisation
https://www.eba.europa.eu/sites/default/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20proposes%20Framework%20for%20STS%20Synthetic%20Securitisation/883430/Report%20on%20framework%20for%20STS%20syntetic%20securitisation.pdf

of the securitisation market.

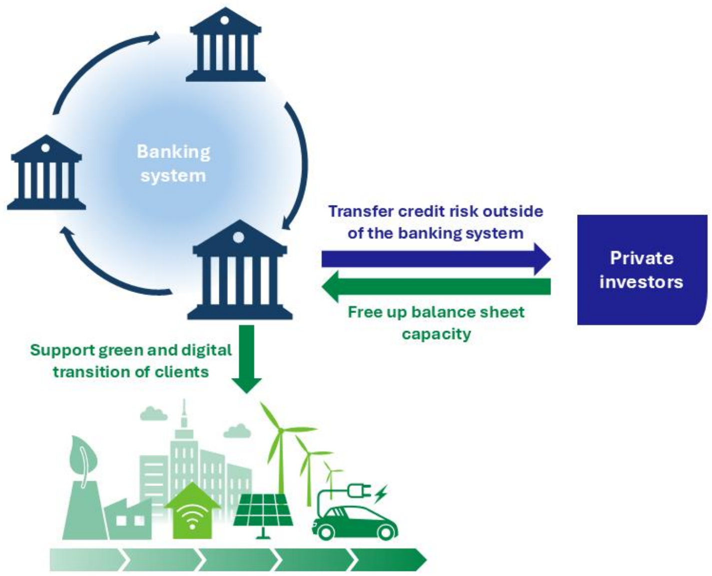
CRS can positively contribute to the goals of SIU

Improving European competitiveness and financing the shift to a climate-neutral economy requires vast amounts of funding and capital. The European Commission evaluates that "overall, additional investments of over EUR 620 billion annually will be needed to meet the objectives of the Green Deal and RepowerEU. By far the greatest part of these will have to come from private funding"[5]. An estimated duration of such investment is between 2023[6] and 2030. Banks have a vital role to play in this transition, in particular in the bank-centric financial system in Europe, yet their lending capacity is constrained. Hence, part of that financing must be raised through the capital markets. For banks to expand their lending capacity securitisation, like CRS, can help and bring private investors' capital.

By pooling together a portfolio of loans, for instance project finance loans, CRS enables institutional investors to unlock banks' additional capacity to lend, helping the real economy to grow and to invest in the green transition. When investing in CRS transactions, we invest in the broader economy and look at how the real economy can become greener, facilitated by both banks and CRS investors.

In addition, a particular characteristic of CRS transactions is that they relate mostly to relationship lending products, which are essential for businesses and difficult to transfer through true sale securitisation. Examples of such lending products are revolving credit facilities and trade finance. These often require a large amount of operational handling that a bank is uniquely set up for and which cannot easily be taken over by a non-bank.

CRS transactions also help the banking sector to manage and spread its credit risk exposures in a sound way, leading to less systemic risk and a more robust and sustainable financial system.



As banks retain part of the risk in a CRS transaction and actively manage the relationship with their clients, they are in a prime position to support the transition of their clients and to report on this effort and the resulting improvements in terms of sustainability characteristics to the investor. Especially in bank driven markets such as Europe.

[5] https://commission.europa.eu/system/files/2023-07/SFR-23-beautified-version_en_0.pdf
[6] The European Commission's "Strategic Foresight Report' was published in 2023

By attracting private, long-term capital from institutional investors and directing it towards stimulating financing of the economy, including the digital and green transitions as well as small and medium enterprises, CRS can add value to the goals of SIU. Yet, regulations are a key factor driving CRS issuance and structuring, therefore, in order to boost the use of securitisation, the functioning of the securitisation regulatory framework must be enhanced.

Adjustments to the securitisation regulatory framework will help to attract investor participation

In our experience, the securitisation regulatory reforms introduced in the EU post-GFC, have had an overall positive effect on the securitisation market. These new regulations have helped to restore investors' confidence in securitisation and to reduce systemic risk. This includes the EU Securitisation Regulation ("SECR") and its requirements on transparency, due diligence, and risk retention. An important part of the framework is the Simple, Transparent and Standardised ("STS") securitisation label and its extension to CRS transactions, which sets 'best-in-class' standards. As a pension fund investor, we highly appreciate these positive changes, which worked well to bring the CRS market to where it is today[7]. Now, it is time for change. Amendments are needed. There are elements of the current regulatory framework which are overly conservative or complex and which do not serve further growth of the market. This is reflected, amongst others, in the high degree of non-neutrality of securitisation capital risk-weights and too detailed ESMA disclosure templates (please see below), reducing the attractiveness of securitisation for both the 'buy' and 'sell side,' and consequently unduly constraining the potential of the market.

The securitisation regulatory framework should be more risk-based and proportionate. We believe that this can be realised by targeted adjustments to the SECR and to bank prudential requirements. Below we provide suggestions for such adjustments.

Due Diligence Requirements

We fully agree that investors should perform a thorough due diligence ("DD") and have access to high-quality data when engaging in securitisation transactions, in particular in junior tranches. Having the essential and good quality DD data will help the market to grow. However, the DD requirements in Article 5 SECR are excessively prescriptive in nature and the DD data is still, too often, lacking in quality. Institutional investors, like ourselves, are in the best position to assess what due diligence is required for investment decisions and hence what data is required. Article 5 SECR in its current, prescriptive form, requires verification of information which is not always relevant. For example, Article 5(3)(b) requires assessment of liquidity enhancements and market value triggers, neither of which are relevant for a private, buy-and-hold investor (which includes the majority of CRS investors). Such irrelevant requirements also increase the costs of investing for existing investors and may discourage new investors from entering the market because of compliance risk. Therefore, we propose adopting a principles-based approach to DD and focusing on the standards of DD data. By doing so, securitisation will become more attractive to investors, which will help the market to grow sustainably. Further, we note that outside the EU and the UK, no such specific requirements apply to investors. As the securitisation market is global, this also raises a question of maintaining a level-playing field with non-EU investors.

Transparency requirements

From an investor's perspective, the transparency requirements are part of due diligence via the relation between Article 5 and 7 of the SECR. As a result, investors are required to verify whether issuers have provided a set of detailed information in a prescribed format of ESMA templates. These transparency requirements are not fit-for-purpose for CRS transactions[8] and via Article 5.1(e) are imposing the verification of disclosure requirements by EU-based investors for transactions issued by non-EU banks. To solve for this, the current reporting templates need to be simplified as a matter of urgency. It would make the compliance with the transparency requirements more efficient. In the longer term, a principles-based approach to the reporting of private securitisation would be the most practical way forward. Ideally, these changes are part of the outcome of the Securitisation Regulation review.

Improvements to the STS designation

As a long-term pension fund investor, we strongly support the STS designation and setting appropriate, high-quality standards in the market. The STS label has been a significant and positive step forward[9]. Yet, for further and more robust growth of the market, and to entice direct participation of institutional investors like ourselves, certain adjustments to the STS criteria are necessary. For CRS transactions, we propose:

- *Collateralisation of counterparty risk*: the characteristic of CRS transactions is that an investor can take pure credit risk to a selection of loans the bank holds on its balance sheet. There is no need to add other risks, such as counterparty risk to the issuer. Investment of the cash proceeds in a reverse repo or collateralised deposit with longer-dated, high-quality collateral and daily margining should be explicitly considered as eligible collateral for STS classification. These are standard mechanisms in the CRS market, and we view them as effective ways to mitigate counterparty credit risk. In addition, the paragraphs in Article 26(e)(10) SECR which allow cash on deposit with the originator subject to a minimum rating, and which further allow national competent authorities to lower the rating requirement for domestic banks, creates a risk of unwarranted divergences in the market, at the disadvantage of investors. The same applies to the paragraph deeming collateral requirements satisfied when the securitisation is in the form of credit linked notes issued by the originator, which creates an unsubstantiated departure from the principle that an investor should have recourse to high-quality collateral, as highlighted in the first paragraph of the article. These paragraphs should be removed.
- *First loss positions in CRS transactions at 20% level of risk retention:* higher risk alignment is the best way to safeguard against opportunistic behaviour or the return of the excesses of 'originate to distribute' models. That is why we believe that 20% risk retention rate for a first loss position in CRS - which is significantly higher than the current regulatory minimum of 5% - is more appropriate and should be reflected in the STS requirements for CRS, especially when the investors does not self-select the underlying loan exposures by name. Please note that we do not advocate for such a requirement for senior tranches of true sale securitisations, which we do not invest in.
- *The STS requirements contain certain clauses which do not contribute to the goal of reducing complexity:* firstly, this is the case for the calculation of the initial loss, which needs to be the highest of provisions and the regulatory LGD, which is systematically biased against the investor. Secondly, the requirement on 'at least one payment made,' Article 26(b)(12), is overly burdensome in its current form, that is, applying on individual loan level. We are happy to provide more detail on these clauses if helpful.

Other potential improvements

Below, we share other suggestions for improving the efficiency and for reducing costs of issuing and investing in securitisation:

A "fast track" approval for transactions issued out of a bank's programme: such transactions would be the same or very similar in terms of their structure, hence there would be no need to change the transaction documentation. Only price may change from issue date to issue date. Such transactions can be executed in a more time and cost-efficient manner. For example, by granting approval for a certain total notional of issuance allows the bank to print several transactions over a pre-agreed period of time

[8] Please see PGGM paper "ESMA templates not fit for risk sharing transactions".
[9] Please see as well PGGM's blog "STS for Credit Risk Sharing is proving a success".

without requiring separate approvals. We note that ideally for every new transaction within an issuance programme some terms & conditions should be allowed to change slightly, such as the tranche width and underlying portfolio criteria.

Streamlining the STS verification regime: currently, both issuers and investors are required to verify adherence to a large number of individual STS criteria. The investors in CRS do not get any direct benefit from investing in an STS transaction versus a non-STS transaction, hence, to require investors to check adherence to the STS criteria is overdone.

Prudential treatment of securitisation

Although PGGM and our client are not directly subject to prudential regulations for banks and insurers, we are aware of their implications for the securitisation market dynamics. In our view, the capital treatment of securitisation positions under the final Basel 3 text is more conservative than the risk characteristics would require it to be. We see scope for relaxing some of this built-in conservatism which will stimulate more issuance and investments.

Therefore, we appreciate the reduction of the p-factor to 0.5 and - for STS transactions – to 0.25 for the output floor calculation in the EU Capital Requirements Regulation ("CRR"). This mitigates some of the concerns on a temporary basis. However, the CRS market would be better helped by having a clear and stable solution, with an appropriate capital treatment of retained senior tranches of CRS transactions issued by banks. This can be achieved through either targeted reductions of the p-factor or by reducing the risk weight floor of the retained senior tranche. The latter is in particular relevant for low-risk portfolios, such as residential mortgages, for which the current 10% or 15% risk weight floor is close to the risk weight of the portfolio, and hence securitisation is not efficient. Furthermore, we note these suggestions have a wider application than A-IRB banks for output floor calculation purposes, which is the scope of the current transitional measures.

We believe that it is important to survey whether there is market interest for securitisation tranches after any adjustments to the prudential framework are implemented, both from the issuing banks perspective and from an investor perspective. For example, we notice that currently there is a limited investor base for very wide tranches to be placed in its entirety and, in many instances, investors use financial leverage to achieve their return targets. Such use of financial leverage creates undesirable feedback loops of risk back into the banking system, which should be avoided. At the same time, there already is an appetite for mezzanine tranches, which we believe can grow significantly, particularly among direct institutional investors, given the attractive risk-return characteristics. This would be easier if (STS) standards are enhanced even further in line with what is proposed in this paper. In addition, by stimulating issuers to structure two tranches - a thinner first loss tranche and a mezzanine tranche, together forming the wider original first loss tranche – the desire to use financial leverage reduces, which will likely contribute to a safer and more transparent financial system.

Conclusions

Credit Risk Sharing can help to finance the transformation towards a more carbon-neutral economy and to achieve the SIU goals. CRS can deliver on this objective when the securitisation regulatory framework, which drives the EU markets, functions well and stimulates the issuance of CRS at fitting, high standards that are suitable for pension funds and other institutional investors. To that end, the adjustments as recommended in this paper should be implemented as soon as possible.