

To: Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (the Agencies) **Date:** 16-01-2024

From: PGGM

Subject: Response to Notice of Proposed Rulemaking on the Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity

Dear Sir, Madam,

We have read your Notice of Proposed Rulemaking on the Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (the "Proposal"), with great interest and we welcome the opportunity to comment on this important subject.

PGGM is a long-standing and well-known investor in first and second loss tranches of private on-balance-sheet synthetic securitisations, also known as Credit Risk Transfer (CRT). We refer to them as Credit Risk Sharing (CRS) transactions. We believe this name better reflects the nature of our transactions, which is a genuine sharing of credit risk between the bank and the investor. CRS is an essential credit risk management tool for banks, particularly in times of economic downturn. CRS contributes to a stable and healthy financial system by sharing credit risk with non-bank investors like ourselves. In the United States (the US) this market is still small relative to Europe, but we see it growing. More US banks are embracing the tool or considering doing so, and therewith CRS is becoming an increasingly important means of credit portfolio management. As we strive for a healthy and robust market for CRS in which we can build long-lasting relationships, we welcome this positive development in the US. Our responses and views should be seen in that context and as such, we will only address issues relevant for this type of securitisations. A healthy market requires a well-functioning and sustainable financial system with well-capitalised financial institutions. To that end, we appreciate your objective of this consultation, and we aim to constructively contribute to the process. In this letter we will first briefly introduce PGGM, explain what CRS is and why and how we invest in this type of transactions, then we will provide our comments on the Proposal with possible solutions to the issues we raise.

We thank you for your efforts on this project. If you have any questions or need any further elaboration on any of the points mentioned herein, please do not hesitate to contact us. We would be happy to discuss our letter further at any time and provide additional information on our investment approach, experience and portfolio composition if desired.

Sincerely yours,

Mascha Canio, Barend van Drooge, Anna Bak and Meindert de Jong

PGGM Credit Risk Sharing

Introduction to PGGM Credit Risk Sharing

PGGM has been investing in CRS transactions since 2006, on behalf of our main client, Stichting Pensioenfonds Zorg & Welzijn ("PFZW"), the € 217 billion (per September 2023) pension fund for the Dutch care and healthcare sector. We typically invest in first loss tranches and thus share the credit risk with the originating bank. We are recognised as one of the most experienced and largest active investors in this segment of the securitisation market. As per end of Q3 2023, we have a portfolio of around € 6.1 billion in these securitisations. This € 6.1 billion portfolio references around € 67 billion of loans related to a diverse group of geographies and asset types across the world. Our portfolio includes transactions with US domiciled banks providing credit protection for loan portfolios between US\$ 10-12 billion in total. Next to this, we provide credit protection to US exposure via transactions with non-US banks, which results in the US being the largest geography in terms of underlying exposures for our CRS portfolio.

In CRS transactions we invest in, a bank buys credit protection on a portfolio of loans from an investor. This means that when a loan in the portfolio defaults, the investor reimburses the bank for the losses incurred on loans in that portfolio up to a maximum, which is the amount invested. Typically, this amount covers the first losses to occur in the portfolio, which is often called the 'first loss tranche'. The size of this tranche is typically chosen in a way to cover at least the expected losses on the portfolio as well as a share of unexpected losses. The bank usually retains the rest of the risk, which is called the 'senior tranche'.

The loans being securitised are not sold by the bank but are referenced, which means they remain on the bank's balance sheet. This way, the bank reduces the credit risk on the securitised loans and remains in charge of managing the loans and the lending relationship with their client itself. CRS transactions are often used for hedging the credit risk on loans that cannot easily be sold. Examples are revolving credit facilities, SME lending and trade finance.

Because CRS offers a perfect hedge, the bank can benefit from a capital relief. However, as the loans are not sold, the only payments a bank can receive are when a loss occurs in the portfolio. Consequently, a CRS transaction is primarily for credit risk hedging and capital management purposes, and not for funding purposes. Given the unique characteristics, CRS transactions provide an excellent tool for hedging exposures for risk managing and attracting risk bearing capital for banks' core activities that are vital for the functioning of the economy and for which other options are not readily available. This is especially the case for the securitisation of SME and corporate loans, which are relationship banking products. The bank typically cannot or does not want to transfer the SME or corporate loans for relationship and / or confidentiality reasons. As a consequence, securitisation of such portfolios must be structured with a synthetic structure and not via a true sale transfer of risk. Next to this, many SME and corporate loan products are revolving in nature and therewith not well-suited for traditional securitisation or other risk and portfolio management tools such as loan sales. These loans are at the core of funding the real economy. As such, CRS transactions contribute to a healthy financial system and economic activity by facilitating the credit provisioning by banks throughout economic cycles. We have been investing in new CRS transactions every year since 2006, including during the GFC and the COVID-19 pandemic, facilitating credit risk hedging and capital

relief for those banks throughout turbulent times as well. When borrowers in the transaction portfolio default and a bank incurs losses, our transactions always cover these loss claims. Due to sufficient tranche thickness and robust structuring, these losses have to date never caused the credit protection amount to be fully depleted, demonstrating that the credit risk on the protected portfolio was transferred effectively. For further details please see our position paper "Simple Synthetic Securitisations" (Annex 1), where we also describe how we address concerns around moral hazard and adverse selection that may be associated with synthetic securitisation. We strongly believe that in soundly and robustly structured transactions the needs of issuing banks, investors and regulators are met, achieving true risk transfer in order to obtain capital relief for the bank, while not exposing investors to risks that cannot be analysed upfront.

Sharing part of banks' credit risk leads to less systemic risk and a more sustainable financial system because (part of) that risk is transferred to investors outside the banking system. In the meantime, the credit facilities remain on banks' balance sheets, so subject to supervision by the bank regulators. As a pension fund asset manager, PGGM highly values the long-term stability and sustainability of the credit risk sharing market in which we can build long-standing relationships with our risk sharing partner banks. Over the past 18 years we have built such long-standing partnerships with strong transaction standards with more than 15 banks globally. Some of our partner banks are domiciled in the US and even more are active in the US. We believe that it shows that long-term stability in the market is achievable. We would very much welcome a further deepening of the US CRS market. This would benefit financial stability, credit provisioning and therewith economic activity in the US. As noted above, we already see encouraging developments with more US banks undertaking CRS transactions and an increased level of regulatory guidance, yet this growth is still fragile. 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. We strongly believe that this objective is only achievable if a balance is found between the long-term interests of banks, investors and regulators.

Because of this conviction, we have since many years become a vocal advocate for harmonisation of practices and appropriate standards for healthy transactions, including proper capital requirements. We have been pioneering the advocacy efforts, for example, to establish the Simple Transparent and Standardised (STS) securitisation framework for CRS in Europe ever since 2015 and we have been engaging both with European and domestic regulators and supervisors, including the European Commission, European Parliament, European Banking Authority as well as UK Financial Conduct Authority and the Bank of England. Throughout the years of our dialogues with international regulatory bodies, we always strive to provide support and insight on the market from the perspective of a long-term pension-fund investor. As such, we feel compelled to share our thoughts on the Proposal and potential issues we have identified.

Comments on the Proposal

Along with our comments in this letter, we would like to express our support for the separate response to the Proposal by the International Association of Credit Portfolio Managers (IACPM). PGGM is a member of the IACPM and shares the concerns set out by the IACPM.

We appreciate the Agencies' objective to strengthen the calculation of risk-based capital requirements to better reflect the risks of banking organisations' exposures and to improve risk measurement across financial institutions. Yet, as mentioned above, we are concerned that the proposed implementation of the Basel III package will have negative consequences for the credit risk sharing market in the US by making CRS transactions uneconomic. Next to this, the Proposal could negatively impact risk modelling and management practices by banks and therewith limiting the availability of high-quality risk metrics and data that are necessary for investors like ourselves to provide credit protection on banks' credit portfolios.

- First and foremost, we see a potential negative impact of the removal of internal models (the advanced approaches) for calculating capital requirements for banks on credit risk modelling practices as well as on the availability of risk metrics and historical data to investors in exposures on banks' balance sheets. We will elaborate on this point further below.
- Second, we note that the proposal with respect to the p -factor for calculation of securitisation exposure RWA, if implemented in its current form, will have detrimental impact on securitisation transactions. To that end we echo the concerns raised by IACPM and we kindly request the Agencies to consider an appropriate adjustment to the p -factor. The calculation and associated risk weights differ substantially between the Internal-Ratings Based Approach (SEC-IRBA) and the Standardised Approach (SEC-SA), with the latter being significantly more conservative, in particular with the p -factor increase. The application of SEC-SA with a p -factor of 1.0 leads to a much higher risk weight of the retained tranche(s) and therefore considerably less capital relief. In addition, compared to SEC-IRBA, SEC-SA requires obtaining credit protection for wider first loss tranches in order to be effective, which increases the cost for capital relief as well. Neither the higher risk weight, nor the wider tranches are related to risk fundamentals for retained senior tranches of on-balance sheet synthetic securitisations.
- Third, it is unfortunate that the Proposal does not implement the Simple Transparent and Comparable (STC) criteria for securitisation, including on-balance sheet securitisation, as such framework has proven to be a success in the EU and could provide one possible solution to mitigate the negative consequences of overly conservative p -factor. We will elaborate on this point further below.

This combined effect on the cost of capital relief will cause many CRS transactions to become uneconomic and thus no longer a viable option for risk sharing or as capital management tool. Considering the importance of securitisation, including CRS transactions

for the overall financing of the economy, we strongly believe that the Agencies should take the opportunity to implement the Basel standard with targeted adjustments to securitisation.

Removal of the use of internal models

We believe the restriction on using internal models (advanced approach) for credit risk capital requirements does not contribute to the goals of the Basel standards. We strongly support the use of internal models for regulatory capital calculations, because under this approach banks are incentivised to model, monitor and manage risk factors constituting the expected loss profile of exposures on their balance sheets in a holistic and comprehensive way. By allowing banks to apply modelled PD, LGD and EAD metrics, as allowed under the Basel's Advanced Internal Ratings-Based approach, banks are incentivised to develop and maintain robust models for these metrics. Under the new proposal, none of these metrics would be modelled as they're replaced by fixed risk weights under both the Standardised and Expanded Risk-Based Approaches. Therefore, under the new proposal less attention will be paid to modelling the factors which determine expected losses. The loss of time spent on modelling expected losses will, in our view, reduce the overall quality of risk management and can potentially adversely impact credit underwriting standards and decisions.

A core element of our investment approach is that we invest in so called blind-pools, meaning we do not know the names of the borrowers in the reference portfolios for which we provide credit protection. We believe that our risk sharing partner banks are better equipped to originate and manage credit risks and that we do not add value by knowing the names of the borrowers in the reference portfolio and replicating the rating of loans ourselves (the latter is generally referred to as a 'disclosed pool' transaction). In a blind-pool transaction, the banks' assessment of the risk profile of the borrowers, typically captured by an internal rating and modelled LGD, are key data points for analysing and monitoring the risk profile of the portfolios we are protecting. These metrics are subject to a thorough due diligence process, in which we analyse the historical track record of the performance of these metrics through-the-cycle in combination with a qualitative overlay on the bank's origination and risk management organisation in order to come to a view on expected losses in various economic scenarios. Therefore, as an investor in blind-pools, we highly value precise and granular risk metrics developed by banks and access to the historical data to calibrate the models. As described above, the restriction on the use of internal models can have a negative impact on the development of these valuable data points and therewith the ability for investors to properly assess the risk profile of underlying portfolios in CRS transactions. This is in particular the case for highly granular portfolios such as SME loan books.

Another potential effect of the disapplication of internal models and instead applying fixed risk weights that are not sensitive to the risk profile of the underlying borrower and credit facility, is that it may impact the underwriting decisions of banks. Banks may be incentivised to pursue business with a higher risk profile and may be less rigorous in debt sizing and loan structuring, as a more prudent approach does not lead to a decrease in RWA consumption and therewith does not result in a higher return on capital. This would be an issue in itself, but also impacts investors in banks' loan portfolios, as the degree of

uncertainty about the underwriting and risk management practices of banks increases. Furthermore, it invokes uncertainty about the representativeness of historical track record data, which were realised under a different capital regime with different incentives.

In connection with the removal of internal models, we also note that implementing the final Basel III standards would have allowed for the introduction of the internal ratings-based approach for securitisation (SEC-IRBA). As already addressed above, the Proposal will materially increase the required capital for (synthetic) securitisations due to the proposed increase of the p -factor under SEC-SA. By allowing internal models for credit risk and its related approach for securitisations, SEC-IRBA, such an undue increase in capital requirements for synthetic securitisations could be avoided.

No STC framework is a missed opportunity.

The Proposal does not implement the criteria for STC securitisation. We believe this is unfortunate as the STC standards set out by Basel can help to better standardise securitisation structures, leading to improved monitoring, and can mitigate some of the risks associated with securitisation. Consequently, high-quality transactions, meeting the STC criteria would justify a reduced degree of conservatism being built into the securitisation capital frameworks through capital non-neutrality. In the case of CRS transactions, this should result in transactions in which the credit risk of the underlying portfolio is effectively transferred in all conceivable situations to the investors, which also translates in minimal risk of the investment in the placed tranche being wiped out completely.

In this context, we take the opportunity to share with you our experiences with the STS framework in Europe, which applies also to on-balance-sheet securitisations and is demonstrating to be highly beneficial to the CRS market in the EU.

This new framework was introduced in April 2021 under the EU's Capital Markets Recovery Package to make it easier for capital markets to support economic recovery from the COVID-19 pandemic. Since then, the framework is proving to be a success. The increased transaction activity in the first years of STS for credit risk sharing shows that the framework adds positive momentum to the development of this market. This is a significant step forward, which surely can stimulate lending to the real economy. Per September 2023, we have closed 9 CRS transactions that have been labelled STS, investing € 1.6 billion and referencing underlying loan portfolios of € 30 billion. We believe that the introduction of an STC framework in the US would bring similar benefits.

In addition, the STS framework in EU has led established issuers to adapt their transactions to meet the STS criteria and has stimulated new issuers to enter the market. Indeed, virtually all CRS transactions we see being issued by EU banks aim to achieve the STS certification. As a result, the transactions done so far have been quite diverse. Please also see our blog post "[STS for Credit Risk Sharing is proving a success](#)".

In this context, we kindly ask the Agencies to consider the introduction of such regime in the US in the near future. If STC for on-balance-sheet securitisations is adopted, a lower p -factor for the transactions meeting the STC criteria, can also be considered in the US.

Simple synthetic securitisation

Why and how we invest in synthetic balance sheet securitisations

Introduction

On 30 September 2015 the European Commission (the 'EC') presented its Action Plan on the Capital Markets Union. In it, the EC has included regulations to stimulate high quality securitisations. The stimulus comes through preferential capital treatment of securitisations that meet a set of criteria. The criteria focus on making securitisations simple, transparent and standardised ('STS' criteria). After careful study and consultation with the industry, regulation on STS criteria has been drafted for true sale securitisations and ABCP securitisations. In the meanwhile the EC has asked the European Banking Authority ('EBA') to do a similar study for synthetic securitisations.

We strongly support the initiative to draft STS criteria for synthetic balance sheet securitisations as we believe these synthetic securitisations can contribute to a more sustainable financial system, add value to the real economy, are conceptually simple and appropriate for standardization. In this position paper we will explain this conviction by highlighting why we invest in synthetic securitisations, what our core investment philosophy is and how we get comfortable with specific risks involved.

PGGM and PFZW

PGGM is a leading pension fund service provider in The Netherlands and currently manages € 181 billion (September 30, 2015) of pension assets for a number of Dutch pension funds, including € 161 billion (September 30, 2015) for the pension fund for the care and healthcare sector ('PFZW'). PGGM and PFZW are both not-for-profit organisations and strongly believe that financial return and social responsibility go hand in hand. Consequently, we have developed a social agenda and a responsible investment philosophy in which we invest in companies, projects and assets in which environmental, social and governance standards are met. Through these initiatives we try to take our responsibility as a financial institution and actively contribute to a more sustainable financial system.

PFZW has given PGGM an exclusive mandate to invest up to 2.5% of their assets in balance sheet securitisations, with a focus on synthetic securitisations. We typically invest in first loss tranches and call these 'risk sharing transactions'. We have started investing in 2006, executing new transactions every year since inception. Adding all transactions together, the amount invested in such risk sharing transactions to date exceeds € 5 billion, relating to loan portfolios of over € 80 billion. We have thus become one of the most experienced and largest active investors worldwide in this segment of the securitization market. Our current portfolio is invested in transactions referencing approximately € 37 billion notional of underlying portfolios with exposure to geographies across the world. By engaging in risk sharing transactions PGGM and PFZW help the banking sector to manage their credit risk exposures, leading to less systemic risk and a more sustainable financial system – one of the pillars of PGGM's responsible investment philosophy.

What are synthetic securitisations?

In a synthetic securitisation a bank buys credit protection on a portfolio of loans from an investor. This means that when a loan in the portfolio defaults, the investor reimburses the bank for the losses incurred on loans in that portfolio up to a maximum, which is the amount invested. This amount therefore provides credit protection for a slice of the portfolio, which is often called the 'first loss tranche'. The size of this tranche is typically chosen in a way to cover at least the expected losses on the portfolio as well as a share of unexpected losses. The bank usually retains the rest of the risk, which is called the 'senior tranche'.

Before closing, the bank and the investor agree on the terms of the transaction, such as the amount the investor is at risk for, the duration of the contract and the loans that are eligible for inclusion in the portfolio. Choosing which loans are eligible can be on a disclosed basis, where the investor knows the exact names of the borrowers of these loans, or on a blind pool basis, where the investor does not know the identities of the borrowers. In the latter case the loans are chosen based on criteria, such as the type of loans, sector, geography, credit risk, et cetera.

The term 'synthetic' comes from the fact that, unlike in a true sale transaction, the loans being securitised are not sold by the bank but are referenced, which means they remain on the bank's balance sheet. This way, the bank reduces the credit risk on the securitised loans and

remains in charge of managing the loans and the lending relationship with their client itself. Synthetic securitisations are often used for hedging the credit risk on loans that cannot easily be sold¹. Examples are revolving credit facilities, SME lending and trade finance, as 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.

Synthetic vs true sale securitisation

Synthetic securitisation serves a different purpose than true sale securitisation. In a true sale securitisation, the bank sells the loans to a Special Purpose Entity ('SPE') and therefore receives **funding** at the closing of the transaction. The bank usually retains the first loss tranche. The investor usually only bears the risk on the less risky senior tranche.

In a synthetic securitisation, typically the first loss tranche is transferred to the investor, while the bank retains the remainder of the risk. The amount invested is typically larger than the amount of capital the bank would be required to hold for that portfolio. Because the securitisation offers a perfect hedge, the bank can benefit from **capital relief** thanks to the synthetic securitisation transaction. However, as the loans are not sold, the only payments a bank can receive are when a loss occurs in the portfolio. Consequently, synthetic securitisation is primarily for credit risk hedging and capital management purposes; and not for funding purposes.

	True Sale Securitisation	Synthetic Securitisation
Sale of assets	Yes	No
Purpose for bank	Funding	Credit risk hedging/Capital management
SPE required?	Yes	Possible, not required
Ownership of assets	SPE	Originating bank
Typical asset types	Consumer loans, credit card receivables, mortgages	Corporate exposures, SME lending, trade finance
Investor's return	Based on cash flows from underlying loans	Based on pre-agreed credit risk premium
Interest rate risk on underlying loans	Hedged separately	Not applicable
Currency risk on underlying loans	Hedged separately	Not applicable

¹ This is called 'balance sheet securitisation' as the securitised loans remain on the bank's balance sheet. The technique of synthetic securitisation can also be used to buy credit protection for assets that the buyer does not actually own; these are called *arbitrage securitisations*. The benefits of synthetic securitisation that come from the fact that the bank retains ownership of the securitised loans are thus not applicable to *arbitrage securitisations*. We do not invest in *arbitrage securitisations* but only in *balance sheet securitisations*. Hence, all explanations in this paper are only applicable to *balance sheet securitisations*.

Complexity

A predominant concern regarding synthetic securitisations is that they are complex. This is not entirely unjustified; the legal mechanism of the credit risk transfer of synthetic securitisations can be structurally intimidating and difficult to fully grasp at first sight. Because of this, we take the appropriate structure for the transaction into careful consideration (see below for detail).

That said, we believe synthetic balance sheet securitisations or 'risk sharing transactions' are **conceptually quite simple**: an investor takes credit risk on a selected portfolio of loans from a bank up to a pre-agreed amount. For this credit risk the investor gets a commensurate return in the form of a periodic coupon payment. In its essence, this is all there is to it.

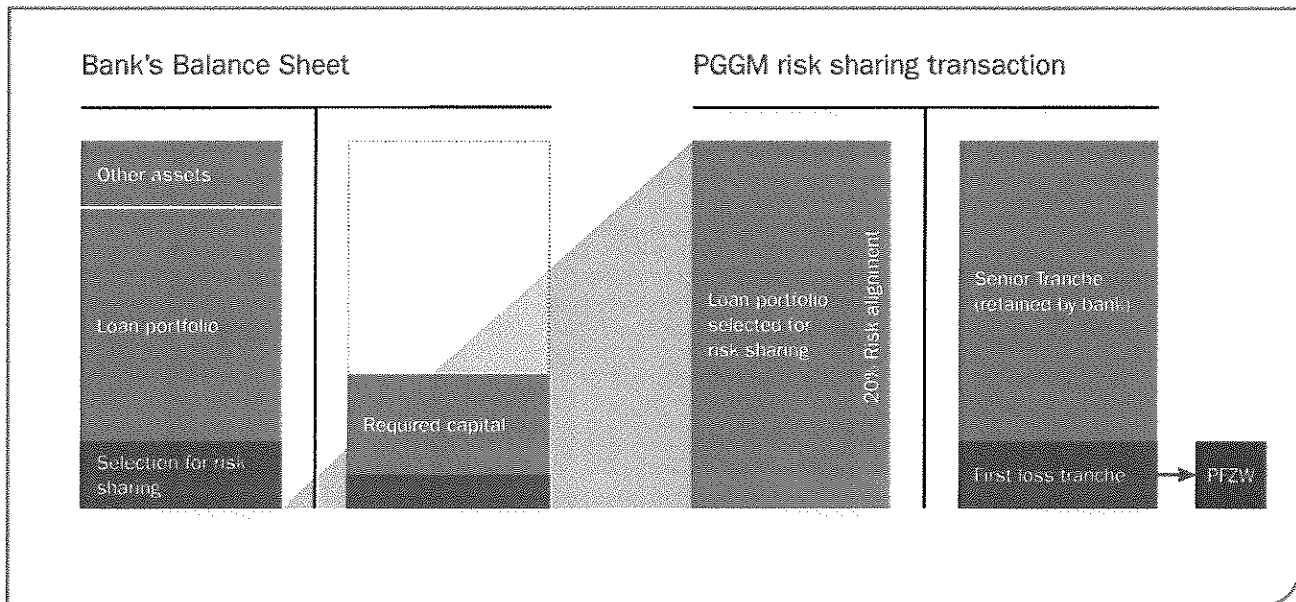
The figure below shows the typical outline of our risk sharing transactions. Together with the bank, we agree on a selection of loans from a particular lending book on the bank's balance sheet that is eligible for the risk sharing portfolio (left side of the figure). Of this loan portfolio, we typically invest in the first loss tranche and the bank retains the senior tranche. In addition, we ensure there is a strong alignment of interest. We structure this by requiring the bank to continue to hold at least 20% exposure to the same credit risks as us. This way, both parties 'feel the pain' when there is a credit loss. Our belief is that this provides for a relatively simple and easy-to-understand risk-return profile.

Concerns

Nonetheless, there are certain justifiable concerns that remain. From the bank's perspective, the main concern is whether the credit risk is adequately transferred through the structure². From an investor's perspective, particular concerns exist over:

- **credit risk**: what type of credit risks is the investor exposed to?
- **moral hazard**: will the bank still service the loans after they are hedged?
- **adverse selection**: will only bad loans be included in the securitisation?
- **operational risk**: will the securitisation structure work?
- **counterparty risk**: is the investor exposed to default risk of the bank?
- **structural risk**: which other risks are created by the structure?

We understand these concerns, and as an investor we share these concerns. In the section below we will first outline our core beliefs, after which we discuss how we address the different elements involved and how we – and our client – become comfortable with these risks.



² This concern is addressed in the guidelines on significant risk transfer and will not be separately discussed here.

Our core beliefs

As mentioned, internally we refer to our investments in synthetic balance sheet securitisations as 'risk sharing transactions'. The use of this term emphasises our principal belief that the transaction should be a genuine sharing of credit risk: any losses we experience as investor under the transaction should be as similar as possible to the losses experienced by the originating bank on loans in the securitised pool.

From this basis follow some of our core beliefs:

- Creating a long-term partnership with the bank;
- In which we share the credit risk regarding their core businesses only;
- In which activities the bank has a well-recognised market position;
- investing in a risk sharing portfolio that is a fair reflection of the underlying loan book;
- with true alignment of interest ensuring losses are shared; and
- no significant counterparty risk for either side.

Addressing the concerns

As an experienced investor in synthetic securitisations we have given considerable thought to addressing the concerns listed earlier, in order to be comfortable that we structure robust transactions with an attractive and simple risk-return profile for our client.

Firstly, what we strive for is a **long-term partnership**, in which we share the losses of the bank on their core credit portfolios in the same way as they are experienced by the bank. Therefore, we always aim to settle final losses in the risk sharing portfolio at the same level as the bank reports them on their profit & loss account, which is in line with how shareholders face such losses. Additionally, as a long-term partner we become very well acquainted with the risk sharing bank. As such, when a transaction matures, we are always available to negotiate a new transaction and ensure that the bank can enjoy continuous credit protection on the relevant loan books. In our almost 10 years' experience, we have built up several such relationships in which we roll over maturing transactions and we continue to strive to build more.

As a starting point for an individual transaction, we believe in **sharing purely the credit risk** of the loan portfolio. We price the credit risk as a simple fee that should be paid periodically. We have a strong preference

for **simple pricing** by avoiding excess spread or other complex mechanisms. The price we demand therefore is completely separate from the interest rate on the underlying loans³, and purely a risk premium related to the perceived credit risk of the loans. The net result for the investor is then, in essence, the risk premium over the outstanding pool minus expected losses. Other risks, such as currency risk, interest rate risk and counterparty risk are mitigated through the structure. How we deal with these risks will be explained below.

To understand the **credit risk** of the transaction we conduct in-depth due diligence on the loan portfolio and the bank and take careful consideration when structuring the transaction. Firstly, understanding the underlying type of credit risk is key. If we do not understand the underlying risk, we will not invest.

Secondly, we focus on credit risk that is forthcoming from a successful **core activity** of a bank in which it has a **well-recognised market position**. To us it is relevant that the activity is strongly embedded in the bank's DNA, gets a lot of attention from senior management and that the bank has the means to ensure it is properly (risk) managed in the firm.

Moreover, we pay significant attention to the bank's **processes** that relate to the (lending) activity we intend to share the credit risk of. We invest a lot of time to fully understand all relevant processes within the bank, who the key people involved are and the bank's track record in these processes. Areas of particular attention are origination, monitoring, work-out, risk management, fit within overall strategy, et cetera. In effect, we 'subscribe' to these processes by entering into a risk sharing transaction with the respective bank.

Knowing the actual individual names of the underlying entities in the risk sharing portfolio is not important to us. What we need to know are the risk characteristics of each line item, such as internal credit rating, industry sector, country, tenor, et cetera. From this perspective, we prefer to start with a reference portfolio that is a **fair reflection** of the bank's total portfolio, which we then tailor to reduce certain concentration risks⁴. The resulting risk sharing portfolio is diversified and the majority of the positions are illiquid names.

We insist there is a strong **alignment of interest** between parties, resulting in the bank holding at least 20% of the same credit risk on their books unhedged. This alignment of interest requirement is of such a size that potential

³ We want to separate the price of the transaction from the interest rates of the underlying loans. A bank may price a loan on the basis of the whole package of services that the bank offers to a client. Accordingly there may be discounts involved that are compensated through other business of the bank.

⁴ Single obligor group limits, sector limits, rating bucket limits and geographical limits are examples of criteria that a reference portfolio has to adhere to.

losses are not easily covered by upfront underwriting fees and an interest payment. The undesired effects of the 'originate to distribute' model are significantly reduced by insisting the underwriter holds sufficient 'skin in the game'. Furthermore, ensuring that the reference portfolio loans are a reflection of a core activity of the bank provides assurance that the bank will continue to service the whole book that is being referenced. At the same time, the alignment of interest requirement safeguards the bank's commitment on the level of the reference portfolio loans. Together these mitigate **moral hazard**.

To ensure **adverse selection** is reduced as much as possible, we require that the internal credit rating of each loan that enters the reference portfolio is up to date. In addition, we insist on a pre-agreed set of selection criteria used to add new exposures to the risk sharing portfolio, typically executed by an automated software program or algorithm. Cherry picking by individuals should at all times be avoided.

To address **operational risk**, the algorithm of this automated program is subject to further due diligence by our specialized operational due diligence team. Furthermore, any credit event in the portfolio that results in a loss claim by the bank will be verified by an independent verification agent to ensure that the claim was validly made before any settlement of losses takes place.

We structure the transaction in a way that avoids **counterparty risk** for either side. Firstly, we always fund the transaction fully by transferring an amount equal to the full notional of the investment at inception of the transaction into a separate account. Consequently, when a credit event occurs, the bank is ensured that cash is available to settle the claim regardless of the solvability of the investor. To further ensure that we, as investor, do not run counterparty risk to the bank, this prefunded cash is typically held at a third party custodian and invested in highly rated, virtually riskless short-term collateral securities: usually 3-month commercial paper of AAA or AA+ rated issuers in the appropriate currency. Examples are German or US T-bills or CP issued by KfW or EIB. If the bank defaults on the credit protection payment, the credit protection ends and the investor receives the remaining investment amount from the proceeds of the collateral, after deduction of claimed losses for credit events. As the collateral securities mature every 3 months, there is also no liquidity risk associated with this structure.

Finally, in terms of **structural risks**, we find that synthetic securitisations are actually easier to assess than **true sale securitisations**. As the loans themselves are not transferred but only referenced in the transaction, and

the hedge concerns only credit risk, the investor is not exposed to interest rate risk or currency risk on the underlying loans. The actual size and timing of the cash flows on the underlying loans do not matter to the investor in a synthetic securitisation as long as there is no credit event. Also, operational and legal risks with regard to the ownership transfer of loans are avoided. Through this approach, we have become comfortable with the perceived structural complexity of synthetic balance sheet securitisations. The standards we have developed internally have proved to create robust and attractive investments for our client in various economic circumstances.

Why develop STS criteria for synthetics

Balance sheet securitisations in general are a risk management tool for banks used to hedge existing exposures. Synthetic securitisation enables the bank to hedge exposures that are difficult or even impossible to sell and therefore cannot be hedged via a true sale securitisation, such as revolving credit facilities, SME lending and trade finance. Synthetic securitisations often hedge credit risks related to an entirely different segment of lending than true sale securitisations do. As such they are complementary to the currently proposed set of STS criteria.

Moreover, the preferential treatment to be provided to true sale securitisations through the STS criteria may disrupt the level playing field between true sale securitisations and synthetic securitisation. This could shift the focus towards true sale securitisations and thereby harm not only the synthetic securitisation market, but also segments of core lending that are unsuitable for securitisation through true sale, including types of SME lending and trade finance as mentioned above. Furthermore, through these transactions a substantial part of credit risk is removed from the banking industry as it is shared by non-bank investors. As such it can reduce systemic risk and contribute to a more sustainable financial system. To ensure that the synthetic securitisations do indeed meet these objectives, it is crucial that they are structured adequately. STS criteria can help meet this goal.

Finally, STS criteria can further help create a more accessible, standardised and transparent market for synthetic securitisations. While the fundamentals of many synthetic securitisations are similar, variation still exists in the implementation. This is partly due to different preferences from investors and banks, as well as varying requirements from the respective regulators of the banks. We believe a more harmonised approach would benefit investors, banks and regulators alike.

Concluding remarks

Our experience has been that the risk sharing transactions we have entered into are mutually beneficial for the banks and our client. The banks receive a perfect hedge on the names in the reference portfolio and often capital relief as well. This strengthens their balance sheet and enables the bank to recycle the capital into new loans and make use of their organisational network and resources in an optimal way. PFZW as investor gets a diversifying investment, through access to credit risks not available in the public market, with an attractive risk-return profile. The returns over the past 10 years have been strong, even during the financial crisis. Finally, society can benefit from an increase in lending to core

banking relationships and a decrease in systemic risk in the banking sector, with a stronger economy and a more sustainable financial system as result.

In this paper, we have given our view on synthetic balance sheet securitisations and how these 'risk sharing transactions' can be adequately structured to mitigate the main concerns. We hope that it gives insight in how to become comfortable with synthetic securitisations and how standardisation can address the public concerns regarding these transactions. We believe that through a relatively limited number of criteria synthetic balance sheet securitisations can be standardised into simple and transparent investments.

Demystifying synthetic securitisations: terminology

A large part of the perceived complexity of synthetic securitisations stems from the jargon used in the industry. This annex strives to demystify some of this jargon.

Credit protection	Protection for credit risk, which is the basis for synthetic securitisations.
Protection buyer	The party that wants to receive credit protection on loans they hold, typically a bank.
Protection seller	The party that offers the credit protection, in short the investor(s).
Credit event	When a borrower cannot repay its obligations. Usually this is separated in three categories: 'Failure to Pay', 'Bankruptcy' and 'Restructuring'.
Credit default swap	A financial contract through which synthetic securitisations are typically structured. In this contract the protection buyer pays a fixed rate of interest (the 'CDS premium') in exchange for a 'floating' payment from the protection seller. Such a 'floating payment' would be the loss amount claimed by the protection buyer, following a credit event on a loan in the portfolio. Abbreviated as CDS.
Reference portfolio	The portfolio of loans that is being referenced in the synthetic securitisation. Any losses in this portfolio will be compensated by the investor, up to a pre-agreed maximum amount.
Tranche	The slice of risk that is being taken in a securitisation. The 'first loss' or 'equity' tranche takes the initial losses and the 'senior' tranche will take the last losses, if any. In between you may have additional tranches, which can be called 'second loss', 'mezzanine' or other terms. Together the loans make up the liability structure of the transaction. To the right is an example tranching structure.

Senior tranche
(last 70%-80% of losses)

Mezzanine tranche
(10%-20% of losses)

First loss tranche
(first 10% of losses)

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