To:	Securities and Exchange Commission	Date:	27-03-2023
From:	PGGM		
Subject:	File Number S7-01-23; Comments on Proposed Rule to Prohibit Conflicts of Interest in Certain Securitizations		

Dear Sir, Madam,

We write to you in response to the Request for Comments on the proposal to implement Section 27B of the Securities Act of 1933, which prohibits conflicts of interest in certain securitisations. We are a long-standing and sizeable investor in a specific segment of the securitisation spectrum, namely in Credit Risk Transfer (CRT) transactions. The proposed rule could have serious consequences for CRT issuance in the United States, which we aim to address in this letter.

PGGM actively supports sound standards for securitisation globally and we are a vocal advocate for healthy transaction structures and supporting regulations. We aim to constructively contribute to the different dialogues across the globe in order to stimulate a growing role for CRT. These types of transactions enable banks to perfectly hedge the credit risk which banks have originated and continue to hold, including illiquid names, without transferring legal or economic ownership of the underlying (loan) contracts. CRT is therefore a risk management tool, allowing banks to achieve capital relief. That makes this type of securitisation different from the better-known true sale securitisations, which are mainly used as a funding tool.

For securitisation to play a constructive role in any financial system, it needs to be well understood and easy to supervise. This way, it can be a valuable credit risk mitigation instrument for issuers (banks) and an attractive investment for investors, adding to the stability of the financial sector as a whole.

Our comments on the proposed rule come from the perspective of an investor in private CRT transactions only. As such, it does not comment on the effects of the rule on other securitisations. In this letter we share with you our concerns regarding the proposed rule, and potential improvements. Along with our comments in this letter, we would like to express our support for the comments set out in a separate response to the Request for Comments 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 further refer to the letter we wrote you in June 2012 on the same topic[1], our views have not materially changed since then.

[1] See: https://www.sec.gov/comments/s7-38-11/s73811-49.pdf

Introduction to PGGM Credit Risk Sharing

PGGM has been investing in Credit Risk Transfer transactions since 2006, on behalf of our main client, Stichting Pensioenfonds Zorg & Welzijn ("PFZW"), the EUR 218 billion 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. As per year-end 2022, we have invested over EUR 7 billion in these securitisations, which we refer to 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. At year-end 2022, our portfolio referenced around EUR 71 billion of loans related to a diverse group of geographies and asset types across the world. We are recognised as one of the most experienced and largest active investors in this segment of the securitisation market.

By engaging in CRS transactions PGGM and PFZW aim to partner with market-leading banks and share in their credit risk exposures that come from long-standing core activities. Sharing part of this credit risk leads to less systemic risk and a more sustainable financial system. As a pension fund asset manager, PGGM highly values the long-term stability and sustainability of the credit risk sharing market, and we believe this requires that the needs of banks, investors and regulators are met in a healthy and balanced way. The many long-standing partnerships with strong transaction standards that we have built with more than 15 banks over the past 17 years, investing in more than 70 transactions referencing over EUR 150 billion in underlying loan exposure and in which risk is genuinely shared between the bank and our client, shows this is achievable.

General comments on the proposed rule

Our response to the proposed rule can be read in the context of your 'General Request for Comment', but does mostly relate to Request for Comment (5.) and (57.). Furthermore, our response comments on the substance of the proposed rule, we do not comment on the legal technicalities or definitions, that is, the form of the proposed rule.

We believe the intentions and goals of the proposed Rule 192 (the Rule) are well-meant and an important regulatory step. As an investor in CRT, we understand the value of avoiding conflicts of interest between issuers and investors in securitisations. The current form of the proposed Rule, however, may effectively ban the use of CRT in the United States. Such a ban would take away an efficient credit hedging instrument for banks and it would remove the opportunity for investors to obtain credit exposures which are not available in the public markets. This surely is not the intention of the Rule, which is to avoid conflicts of interest between securitisation participants (issuers or sponsors) and investors. In CRT transactions with proper risk alignment, that is, where the bank is required to retain a material part of the securitised credit risk unhedged on their balance sheet, the bank and the investor are aligned and no conflict of interest exists. After all, because of this unhedged risk retention, a loss on a credit exposure would always result in a net loss by the bank, even if it also results in a credit protection payment under the securitisation.

In this context, it may be useful to refer to two different types of synthetic securitisations, as recognised among market participants and other regulators, such as the European Banking Authority (EBA). The EBA distinguishes between two types of synthetic securitisations: on-balance-sheet synthetic securitisations and arbitrage synthetic securitisations.

- In on-balance-sheet synthetic securitisations, the originator uses a financial guarantee or credit derivative to transfer the credit risks of assets which it holds on its balance sheet. The risk is transferred to a third party, an investor in the securitisation. This type of securitisation is often referred to as CRT in the US and is what we refer to as CRS.

- In arbitrage synthetic securitisations, the objective is to benefit from a difference in higher spread received on some underlying assets versus paying the lower spread on the resulting securitised exposure. In such securitisations, the originator may have no material interest in the underlying asset. As a consequence, an originator could sell or market a securitised products to investors, while at the same time taking a short position against the exposures underlying the securitisation. This is a clear conflict of interest and we would not advocate against a prohibition on this behaviour.

While we do not oppose the ban of the arbitrage synthetic securitisations, the proposed Rule may prohibit the use of both on-balance-sheet and arbitrage synthetic securitisations. The ban occurs because, as described in Request for Comment (57.), the securitisations are often structured using a Special Purpose Entity (SPE). In this structure, the SPE sells a credit-linked note (CLN) to investors, performance of which is linked to the performance of underlying loans. Simultaneously, the SPE enters into a financial guarantee or credit default swap with the issuing bank, under which the bank receives payments when the underlying loans incur losses. When an underlying loan defaults, the investor loses part of its investment, while the bank receives a payment: the credit risk is transferred from the bank to the investor. As both the bank and the SPE are securitisation participants, the combination of CLN issued by the SPE and the financial guarantee entered into by the issuing bank constitute a conflict of interest under the proposed Rule. However, in case of on-balance-sheet synthetic securitisations, such a conflict does not exist.

In on-balance-sheet synthetic securitisations, the originator holds the underlying assets on its balance sheet. Therefore, adverse performance of the underlying assets would not benefit the bank as long as the exposures are not 'over-hedged'. Over-hedging can be avoided by appropriate risk retention: we always require that a bank must continue to hold a minimum of 20% on each exposure in the securitised pool unhedged on their balance sheet. Prior to a loss being paid, an independent verification agent (typically a big-4 accounting firm) must independently verify that this risk retention has been met for the defaulted exposure. As a result, when the investor bears a loss, the bank will also incur a loss which is at least 25% of the loss incurred by the investor.
To further reduce potential conflicts of interest, we require two additional features in each transaction. The first is rating affirmation, which means the bank needs to affirm the current ratings are up-to-date and reflect the credit risk of obligors in the underlying pool. Rating affirmation addresses information asymmetry between the bank and the investor. This can be done through

representations by a bank that, at or just before closing, the bank has no indications that a rating change would be required or alternatively through excluding obligors with indicators which show imminent credit deterioration at the time of inclusion. The second feature is a requirement to use rules-based selection of the underlying pool of loans, for example a selection algorithm. This feature ensures a bank has no direct influence on which loans are selected for risk sharing, which avoids "cherry picking" and potential conflicts of interest.

We believe the proposed Rule could be adjusted to avoid a ban on CRT transactions, for which we refer to the Request for Amendment in the IACPM's response to the Request for Comment as a potential adjustment.

Additional conditions on an exemption for CRT could be a minimum of 20% of the risk in the underlying exposures is retained unhedged by the bank. The minimum risk retention could be bolstered by verification requirements, rating affirmation, and rules-based portfolio selection, as described above. Appropriate risk retention strongly mitigates the risk of a conflict of interest, as the bank has no net-economic benefit from the securitisation: when the investors suffer losses, the bank suffers a loss.

Concluding remarks

The above letter is written from our perspective as the largest single direct long-term investor in credit risk sharing transactions, being a Dutch pension fund, who is dedicated to developing this segment of the securitisation market in a sound and sustainable way. We believe that this market has strong potential to grow further in the United States and across the globe and to continue to be an important tool for capital and risk management for banks. We always aim to be constructive and to consider issues not only from our position, but also from the position of banks and regulators. After all, for a healthy and vibrant CRS market it is crucial that the interests of regulators, banks and investors come together.

We would be happy to discuss our letter further at any time. Should you have any questions or require any elaboration on any of the points mentioned herein, please do not hesitate to contact us.

Sincerely yours,
Mascha Canio, Barend van Drooge and Jan Peeters Weem
PGGM Credit Risk Sharing

PGGM