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Responsible Investment in Credit Risk Sharing

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1. Introduction

As a long-term investor, PGGM Vermogensbeheer B.V. (PGGM Investments, hereinafter PGGM) is committed to investing responsibly. On behalf of Pensioenfonds Zorg en Welzijn (PFZW) PGGM has been investing in Credit Risk Sharing (CRS) transactions since 2006. PFZW structurally allocates to CRS transactions ever since, and sees it as a relevant part of its overall portfolio composition, and contributing to a stable pension for their participants while also taking into consideration the impact these investments are having on the world around us. PGGM recognises that environmental, social, and governance (ESG) factors have a material impact on the financial performance of the portfolio, especially in the longer term. As such, integrating attention for potential ESG issues into investment analysis and decision-making processes is part of its fiduciary duty.

This guideline addresses PGGM's management of ESG issues with regard to CRS. The guideline is a further refinement of PGGM's Responsible Investment Framework and its implementation guidelines. In addition, the obligations arising from compliance with legislation and regulations apply. The guidelines cover all investments made by CRS, effective as of 1 January 2021.

2. Investment strategy & approach

The CRS mandate is managed internally by the Credit & Insurance Linked Investments (CILI) team which is part of the Private Markets Department. On behalf of PFZW, the CILI team invests in loans that banks provide to their clients. The focus and approach is a relatively unique one. The loans remain on the balance sheet of the bank and if a loan defaults, PFZW and the bank share the losses. Through these transactions, called Credit Risk Sharing (CRS) transactions, PFZW shares in credit risks the bank holds as part of its core and successful lending activities. These investments are a specific, dedicated part of PFZW's credit risk exposure within the overall investment portfolio. Through sharing in the credit risk, PFZW is able to diversify its credit risk to exposures not available in the public market. For partner banks this presents an attractive way to attain loss-absorbing capital required for these activities. For more detail, please refer to the CRS website of PGGM.

The primary goal of the CRS investments is to generate high and stable returns throughout the credit cycles, while diversifying PFZW's credit portfolio by tapping into credit risks not accessible via public markets. We invest on the basis of a buy-and-hold strategy and by entering into bilateral and sizeable transactions, enabling us to perform in-depth due diligence and negotiate soundly structured transactions.

We aim to participate in the core business of the bank and build a long-term relationship. This enables us to get to know amongst others the loan origination and risk management processes of the bank increasingly well. This is achieved through our thorough due diligence process and also via the monitoring of our individual transactions. This feedback loop provides an opportunity for continued dialogue on the choices made, directly with the people driving these processes within the banks.

The CILI team's focus regarding responsible investing for CRS transactions can be divided into two main themes. Firstly, we believe these risk sharing transactions can contribute to a more stable financial system and add value to the real economy. By entering into a CRS transaction, the bank will free up capital which can be redeployed and will enlarge the bank's capacity to lend. In addition, we consciously take up our role as one of the largest investors in this asset class in promoting and contributing to financial system stability. We do this by exchanging views with market participants and regulators on how CRS transactions can be structured in a sustainable way to ensure genuine risk sharing that indeed contributes to a stable financial system.

Secondly, when selecting the banks to partner with and the loan portfolios in which we share the risk, ESG factors are an integral part of the analysis and decision process. ESG factors represent a wide range of aspects which can have an effect - directly or indirectly - on the borrower's ability to service its debt obligations in the future.
We strongly believe that banks taking these factors into account are better equipped to assess credit risk of their clients.

Contributing to a stable and sustainable financial system

By engaging in CRS transactions PGGM and PFZW help the banking sector to manage and spread its credit risk exposures in a sound way, leading to less systemic risk and a more sustainable financial system. This is visualised in the core pillars of the CRS investment philosophy: build long-term relationships with our counterparties, by participating in the bank's core business and by requiring the bank to maintain a strong alignment of interest.

To ensure alignment of interest in the structure of a CRS transaction, we require that the risk-sharing bank retains at least 20% exposure to each borrower referenced in the transaction. When a credit loss occurs, both PFZW and the bank will suffer a loss. We feel it is crucial for the bank to maintain a substantial amount of the same credit risk that PFZW is exposed to, and have applied this approach since the start of the mandate in 2006.

The merits of this has been re-enforced by the global financial crisis of 2008. The originate-to-distribute model which the market had developed into for certain types of structured products, has significantly contributed to the depth of the crisis, and arguably has been one of the root-causes. In 2013, regulation in both the US and Europe has changed to require the originator to maintain a minimal 5% risk retention. We welcome that change and at the same time continue to adhere to our minimum of 20% to ensure continued focus by the bank on every loan position in our risk sharing transactions.

In addition and to further ensure sustainable CRS transactions, a guiding principle is that we only participate in the bank's core business. This is business in which the bank has built a strong expertise and to which it will continue to dedicate high-quality resources for the foreseeable future. To avoid "cherry picking" the loan portfolio itself has to be selected in a non-discretionary way, to ensure it is a good reflection of the bank's overall loan book.

Responsible investment as a core element

When selecting the banks to partner with and the loan portfolios in which we share the risk, ESG factors and the related risks are an integral part of our analysis and decision process. We strongly believe that banks taking these factors into account are better equipped to assess credit risk of their clients. Accordingly, this is expected to help reduce both investment and reputational risks and over the longer term contribute to maintaining high and stable (expected) returns of the portfolio.

By having in place transparent responsible investment guidelines for CRS, as further outlined in this document, and by actively taking into account ESG-related performance in investment decisions, the CILI team believes that it offers a positive contribution that is best practice and in line with the clients' stated objectives.

The CILI team aims to be fully compliant with obligations arising from relevant legislation and regulations. For more detailed information please see the PGGM Investments website.

3. Implementation

3.a ESG-integration

PGGM defines ESG risks as risks for the financial returns of our investments from material ESG factors. ESG integration accordingly is defined as systematically assessing and taking into account those ESG factors that have a material effect on investment risk and return. Transitional and physical risks deriving from climate change are considered a sub-set of ESG risks and are therefore covered by the ESG integration process of CRS. In our view, ESG risks present real (financial) risks that can have a negative effect both directly and indirectly on the borrower's ability to service its debt obligations in the future. Consequently, this could have a negative effect on the value of our investments in the medium to longer term in case not managed well.

When looking at transitional and physical risks derived from climate change, examples of ESG risks are companies that fail to address their business model as the world transitions to a low carbon economy and could be impacted by stricter fossil fuel (or environmental) regulation. Physical climate risks will further expose companies in flood- or draught-prone areas, as well as companies depending on suppliers in those areas. Further, ESG risks can also unfold due to public controversy on companies and the resulting loss of business. Therefore, we strongly believe that banks taking such ESG factors into account when considering lending to these clients and when assessing the risk profile of their clients are better equipped to assess and manage credit risk.

Selection of counterparties and loan portfolio

During the initial phase of a potential CRS investment the CILI team assesses whether there are specific ESG topics to consider with regards to the envisaged risk-sharing bank, as well as the industry sectors and countries in the envisaged portfolio of loans for the risk sharing transaction.

Next to our own view points, we utilise country, sector and bank-specific research from dedicated research firms like MSCI and Sustainalytics, to give guidance regarding which topics the due diligence should focus on and to determine which exclusions we potentially would like to make with respect to the underlying loan portfolio we will be exposed to. These reports serve to provide examples of where controversies have arisen in the past, in relation to the banks' lending activities in the relevant countries or industries. Relevant topics will be discussed during the due diligence interviews. The bank's overall ESG rating, together with the ranking of the bank on the PGGM Sustainability Ranking list, is relevant for determining a more general view on whether the bank fits PGGM's profile of a valued long-term risk-sharing partner. The list scores PGGM's financial counterparties on how they contribute to a stable and sustainable financial system, and has the purpose of stimulating the counterparty in question to take action resulting in a higher score.

ESG focus during PGGM's due diligence process

In light of the due diligence performed, it is relevant to note that the loans in which we share the credit risk remain on the banks' balance sheet and continue to be

part of the bank's risk management processes. The risk sharing is realised by means of a bilateral contract with the bank, based on which the bank will receive compensation in case a loan is not repaid. This means it is instrumental to develop a thorough understanding and assess the quality of the loan origination and monitoring process of the bank we partner with. The way in which the bank takes into account ESG factors is an integral part of that assessment.

During our assessment of the banks origination strategy and quality of the risk management process, we investigate which ESG policies the bank has implemented and how these fit with the policies of PGGM and PFZW, how the bank ensures the policies are being adhered to and impact the bank's decisions, and to what extent the convictions behind these policies are part of the bank's culture.

ESG lending policies

We investigate whether the bank has defined policies, relevant to its regions and client base. For instance, on sectors where pollution and impact on the environment play a role we seek for the bank to set clear guidelines on what activities it will not finance or require approval at higher level of seniority and input from sustainability risk managers. In addition, and equally important, we compare these policies to the position of PGGM and PFZW on responsible investment. Examples of sectors where PFZW has a clear position are mining, oil & gas, forestry and palm oil. In the case of project finance, we verify if and when the bank has signed up to the Equator Principles. If the policies are not publicly shared, we request to receive the policies as part of our due diligence, in order to see the scope and depth of the framework. When entering into a CRS transaction, we continue to follow the development of the ESG lending policies of the bank. Over the last years have seen positive changes in this respect.

We look into the bank's approach and course of action in case of sensitive sectors or ESG-related topics.
In some cases, banks will pursue engagement instead of exclusion, by setting clear goals as part of the financing facility they provide, in that way motivating the company towards the desired change of behaviour.

Integration & governance

As part of our due diligence we establish how the ESG lending policies are governed. Who provides input and has authority to make decisions with respect to the policies followed and the lending decisions. Besides verifying that appropriate policies are applied, we also verify to what extent the bank's employees, who the CRS deal team meets during the various due diligence conversations, demonstrate a true knowledge of these policies and how they form part of the bank's credit approval process. The CRS deal team reviews actual loan proposals to see how the assessment of ESG risks takes place in practice. We assess which decision-making bodies are involved when potential ESG issues arise, who is responsible for flagging, and whether there is sufficient countervailing power between risk management and the business.

Impact on lending decisions

During the meeting with representatives from the relevant departments involved in the loan origination and monitoring processes of the bank, we will ask to illustrate with examples of where the bank has had elaborate internal discussions, taken action or in the end decided to not pursue or exit an existing relationship. We ask whether the bank has specific internal targets related to ESG standards or risks.

Culture

The meetings with representatives from the bank help us to determine to what extent the policies that apply are indeed embraced by the wider group of individuals that are the day-to-day guardians of it. Part of this is to investigate how employees are made aware on the bank's targets in this respect.

3.b Impact

In addition to a more resilient and potentially better performing portfolio, the CILI team supports the Responsible Investment policy of PFZW. We seek to contribute to enhance the positive impact of the investments and to minimise adverse impact even when they do not directly affect the financial performance.

1. Positive impact: investing in the SDGs

In 2016, PGGM and APG defined Sustainable Development Investments (SDIs) as "investments that yield market-rate financial returns while generating a positive social and/or environmental impact", hence contribute to the Sustainable Development Goals (SDGs). In 2020, AustralianSuper and British Colombia Investment Management Corporation joined APG and PGGM in the SDI-Asset Owner Platform which developed a taxonomy for defining how corporations contribute to SDGs. The SDI-platform owns and markets different products and services for investors to apply such taxonomy to their investment portfolio. The taxonomy represents a set of decision rules which identify to what extent investments classify as 'SDI'. The decision rules

are based on the indicators suggested by the Working Group on SDG impact measurement of the Sustainable Finance Platform facilitated by the central bank of the Netherlands[1].

PFZW's ambition is to increase the SDI volume to 20% of its total portfolio by 2025. The effort to measure portfolio companies' real-world impact is focused on seven SDGs that are considered most relevant to the beneficiaries of the pension fund and the type of investments of PFZW: #2 (zero hunger), #3 (good health and well-being), #6 (clean water and sanitation), #7 (affordable and clean energy), #11 (sustainable cities and communities), #12 (responsible consumption and production) and #13 (climate action).

A good example of 'Sustainable Development Investments' within CRS is a transaction entered into in 2008 (renewed and increased throughout the years) in which we share the risk of a portfolio of project finance loans of which approximately fifty percent relates to renewable energy projects and the healthcare sector. By entering into this transaction the bank freed up capacity and could expand lending to renewable energy projects. The CILI team is actively pursuing to expand the allocation to CRS transactions that positively contribute to one of the seven focus SDGs.

Next to this, we look to establish reference loan portfolios with a sizeable component of lending to companies with a high ESG rating or which have demonstrated to be leaders with respect to ESG-related topics. An example could be companies that have taken (or are taking) important steps to reducing CO_2 emissions.

The challenge has been to find risk sharing banks that hold sufficiently large and granular portfolios of loans that can be seen as contributing to specific causes like the ones mentioned in the United Nations Sustainable Development Goals. Today the amount of such loans on the bank's balance sheets is still relatively small and fortunately growing. There is also a practical challenge for increasing the relative amount of SDG-focussed credit exposures. Banks are seeking ways to determine how to best measure their clients performance on aspects like CO2 footprint and positive contribution to the SDGs. We see the opportunities for creating these dedicated, SDG impact-focused loan portfolios growing.

We signal an increased ambition among banks to focus their lending activities on companies that provide a positive contribution to climate related challenges. Funding of this type of activities can be dealt with via Green Bonds. Capitalisation of these loan portfolios could be attractively done via tailor-made CRS transactions. We continue to engage with our relationship banks on this topic and are hopeful to increasingly invest in CRS transactions with a positive impact.

2. Minimise negative impact

The social and environmental impact of the capital entrusted to PGGM by its clients is significant. PGGM can stimulate a positive contribution to a sustainable world and has the responsibility to minimise adverse impact. Adverse impacts refer to negative impacts (harm) to individuals, workers, communities and the environment. As from 1 January 2022 at the latest, PGGM shall avoid new investments in companies that are in very severe violation of the OECD Guidelines for Multinational Enterprises (hereinafter OECD guidelines) and/or the UN Global Compact principles. When feasible, PGGM shall undertake best efforts to divest existing exposures to these companies all together and/or shall engage with the companies, or a selection thereof, that are in (very) severe violation of the OECD guidelines and/or the UN Global Compact principles.

Based on its high likelihood and severity, climate change as a driver of adverse impact is prioritised. Clients of PGGM's have committed themselves to the Dutch Climate agreement and to the Paris Climate Agreement to align policies consistent with the objective to limit the global temperature rise to a maximum of 1.5 °C. The ambition is to have a climate neutral investment portfolio by 2050, in line with the ambition of the European Union and the Paris objectives.

The CILI team is committed to gather data from our risk sharing banks on the emissions of the underlying loan portfolios. We are in on-going discussions with various banks how to measure CO2 emissions of a risk sharing portfolio level. Ultimately, we would like to report an improvement over time making its contribution to the Paris Climate Agreement visible.

3.c Stewardship (engagement, voting, shareholder litigation)

PGGM actively uses its influence as a shareholder to achieve improvements in the ESG field, thereby contributing to the quality, sustainability and continuity of companies and markets. PGGM sees it as its responsibility to engage with market parties and companies about their policies and activities. In this way, PGGM attempts to realise ESG-related improvements. If PGGM is a shareholder in a specific company it applies customised voting principles, written down in the PGGM Voting Guidelines.

1 De Nederlansche Bank.

The CILI team engages with the risk-sharing bank via different angles. During the above described due diligence process we put emphasis on the value of ESG analysis done by the bank. This has a challenging and hopefully thought-provoking effect. On an anonymous basis we inform banks on the performance of peers that demonstrate best-in-class behaviour in this field. By stressing that ESG is important to us when evaluating bank loan exposure, we hope banks will improve on how they take into account ESG risk.

For instance, over the last few years we have challenged banks on how they incorporate ESG risks within their risk process and suggested to apply specific ESG ratings to their clients. We are seeing a positive momentum in respect of separate ESG ratings determined by the bank for individual companies they lend to. A handful of banks has started to use an ESG rating, while various others are working on establishing an appropriate framework. We strongly welcome this development and think it is relevant to capture this more indirect credit risk. Furthermore, the CILI team is actively approaching banks on opportunities for risk sharing in loan portfolios which focus on companies that provide a positive contribution to climate-related topics.

3.d Exclusion

The PGGM Implementation Guidelines on Exclusion are applicable to investments in all asset classes, including CRS. The PGGM-wide product-based Exclusion List consists of companies engaged in controversial weapons, tobacco, tar sands as well as thermal coal utilities and mining companies. As the CRS mandate will often share in exposures not available in public markets, we also apply the exclusion list in the spirit of what the list sets out to do. In practice this means we exclude the industry sectors Tobacco, Defence and Gambling as a whole instead of only excluding certain listed names. Within the Oil & Gas sector we apply specific exclusions such as companies that have operations in tar sands and oil sand extraction next to any borrower that derives more than 10% of its revenues directly from thermal coal mining and/or energy generation. With regards to specialised lending like project finance, the exclusion list is applied on a look-through basis. As the borrower in these cases is a legal entity specifically established for that project, the list is applied to the main sponsor(s) to that specific project rather than the borrower itself.

By excluding on the basis of the above elements, PGGM seeks to prevent PGGM-managed investments contributing financially to practices incompatible with the standards and values of PGGM, its clients and their beneficiaries.

4. Transparency

For each CRS investment, we provide a clear overview of our findings related to the relevant ESG factors based on the country, sector and bank-specific research and the topics discussed during our due diligence interviews. The resulting overall ESG rating of the bank is also reported in our investment proposal and due diligence report. This way we ensure that for each transaction our ESG assessment and related decision making process is reported in a transparent way.

In addition, the CILI team contributes to the PGGM Investments Annual Integrated Report and reports on its responsible investment activities in the Principles of Responsible Investment (PRI) annual survey.

5. Annex

Please note that there is an Annex applicable for this ESG-guideline. This Annex forms an integral part of this ESG-guideline and may be updated from time to time. The applicable Annex is available on our website.

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