PGGM Responsible Investment policy in Credit Risk Sharing

January 2019

Introduction

Pensioenfonds Zorg en Welzijn ('PFZW') 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 categories not available in the public market, and for partner banks this presents an attractive way to attain loss absorbing capital required for these activities. For more detail, please refer to PGGM's position papers[1] on CRS transactions.

PGGM manages, under an exclusive mandate, PFZW's investments in CRS transactions. The mandate is managed internally by the Credit & Insurance Linked Investments ('CILI') team which is part of the Private Markets Department. This document addresses how PGGM takes into account environmental, social and governance (ESG) aspects when investing in CRS transactions.

Vision

It is a core belief of PGGM Investments that sustainable development is necessary in order to generate good and stable investment returns in the long term. PGGM believes that by leveraging the driving force of investments for our clients it can and must make a positive contribution to sustainable development through its investment decisions.

In order to make this vision more concrete, PGGM has identified three different pillars for implementation of its responsible investment beliefs and has selected, in consultation with clients, seven key areas of focus for its responsible investment activities. These are depicted in figures 1 and 2.

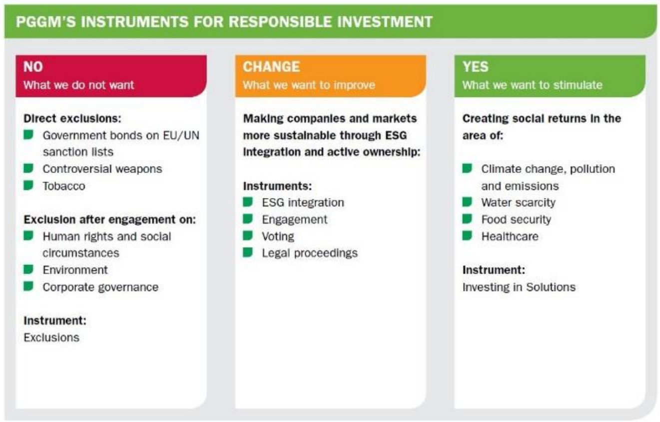


Figure 1: Instruments for responsible investment

- Climate change, pollution and emissions
- Water scarcity
- Food security
- Healthcare
- Safeguarding human rights
- Good corporate governance
- Stable financial system

Figure 2: The seven focus areas

With regards to CRS transactions, the most important area of focus out of the seven listed above is to contribute to a stable and sustainable financial system. This is fully reflected in the way PGGM engages in CRS transactions and structures the risk sharing agreements. In addition, for CRS transactions the three instruments for responsible investment are implemented in the following way:

- **NO**: The PGGM direct exclusion list gets applied to the loan portfolio referenced in the risk sharing.

[1] "Our approach to investing in Credit Risk Sharing transactions" and "Simple synthetic Securitisation – Why and how we invest"

- **CHANGE**: ESG factors are integrated in the due diligence PGGM performs in any CRS transaction. We also engage with our risk sharing partners to further develop their ESG policies and practices.
- **YES**: We stimulate CRS transactions where the loan portfolio includes financing to companies or projects that specifically contribute to the four solution areas mentioned in figure 1.

In the below paragraphs we elaborate on this in more detail.

Objective CRS

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 the loan origination and risk management process 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, and as referred to above, 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 credit risk sharing 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.

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 corporate clients.

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.

NO: Exclusions

The PGGM Implementation Guidelines on Exclusion are applicable to the investments in CRS transactions.

PGGM's Exclusion List consists of a list of corporates as well as countries which PGGM refrains from investing into based on ESG-related considerations.

The corporates to be excluded are determined by the PGGM Responsible Investments team, which engages with companies on ESG-related topics. This list is focused on publicly listed 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 and Defense as a whole instead of only excluding certain listed names. 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.

The country and company exclusions are mainly based on the sanction lists of the United States, the UN Security Council and the European Union.

CHANGE: ESG in the investment decision process

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.

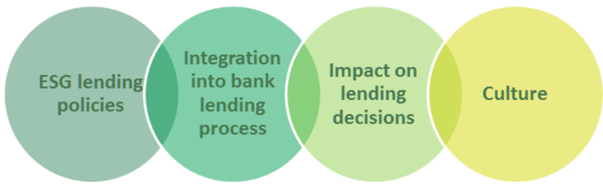
Next to our own understanding, we utilise country, sector and bank-specific research from dedicated research firms like MSCI and Sustainalytics, to give guidance regarding which topics the due diligence should focus on. These reports serve to provide examples of where controversies have arisen in the past, in relation to the banks´ lending activities in the relevant countries or industries. Those 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 objective to maintain the dialogue on their respective ESG policies.

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 part of the banks' balance sheet and 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, how it ensures these 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.

Core pillars CRS due diligence assessment



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. Examples of such sectors 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.

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 arise, who is responsible for flagging, and whether there is sufficient countervailing power between risk management and the business.

Impact
During the meeting with representatives from client relationship management as well as risk management, 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's relationship management and risk management teams 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.

CHANGE: Engagement

The CRS 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 incentivize the bank to 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 highly stimulate this development and think it is relevant to capture this more indirect credit risk.

Furthermore, the CRS 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: Investing in solutions.

YES: Investing in solutions

A good example of 'Investing in solutions' within CRS is a transaction 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 transaction was entered into in 2008, and further exposure was added in 2009 and 2017. The CRS team is actively pursuing to expand the allocation to these types of CRS transactions, where additional capacity is created for lending that contributes to specific ESG related topics. 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 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. As today the amount of such loans on the bank's balance sheets is still relatively small, but fortunately growing, the opportunities for creating these dedicated, ESG impact-focused loan portfolios is growing as well. A factor contributing to the challenge is the size of the overall CRS portfolio, currently[2] around €5.6 billion. The typical minimum transaction size is €100 million. For the right ESG-focused transaction we apply a lower size hurdle than we would do for a regular transaction.

That said, 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 these 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 existing

[2] As per December 31st, 2018

as well as prospective relationship banks on this topic and are hopeful to increasingly invest in solutions through CRS transactions.

For more information on PGGM Responsible Investment in Credit risk Sharing transactions please contact the PGGM Credit & Insurance Linked team via Mascha.Canio@pggm.nl or visit our website www.pggm.com

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