



The Benefits of Securitisation

Securitisation benefits issuers, investors and the real economy

Executive Summary

With this paper we intend to outline the principal benefits of securitisation and provide real-life examples of the legitimate—and beneficial—use of securitisation to support the real economy among a wide range of asset classes, for the betterment of society. This paper does not go into the detail of the currently proposed regulation regarding simple, transparent and standardised (STS) securitisations. All parties involved in the drafting of this paper—Santander, PGGM and APG—have separately commented on the contents of the proposed regulations.

APG, PGGM and Santander are three major players in the European securitisation market. APG and PGGM are two of the most active European investors in the securitisation market while Santander is one of the major arrangers and issuers of ABS securities and risk sharing transactions, executing transactions in 13 countries across the European continent regarding a wide range of different loan types, such as SME loans, car loans and project finance loans.

We are keenly interested in promoting a safe and growing securitisation market that can benefit the real economy in Europe. We think securitisation, which in the run-up to the financial crisis of 2008 has been discredited by the actions of certain players in the market, can and should be used as a perfectly legitimate funding and capital tool.

For each loan granted a bank needs two things: cash to provide to the borrower (funding) and a buffer to account for potential non-payment (capital). Securitisation is a technique that can help a bank attract funding and strengthen its capital ratios in a diversified way. For investors it provides attractive and diversifying investments without the need to set up a complex and expensive client-facing infrastructure. Instead they can benefit from the lending and servicing expertise of (experienced) originators. Securitisation can be used for a large mix of lending types and borrowers: from consumers and SMEs to large corporates and from car loans to renewables financing.

As such it can provide benefits to society by funding, risk sharing in and recycling capital for real economy loans, while avoiding the pitfalls of the past. From a prudential point of view, it is not considered sensible for banks to keep all their loans on their books. It is better for the stability of the financial system if the loans (assets) are spread among investors offering risk diversification for banks and investors. Removing the loans from the balance sheet of the bank means banks can create more new lending which is good for the economy.

Securitisation is a technique for pooling loans and then distributing the pool among investors. It differs from a fund in which shares can be purchased because the securitised investments have “tranches” with different levels of risk which also suits different types of investors. When investors purchase the most subordinated tranches, they share especially in the credit risk of the loans, which enables banks to reduce their concentrations of risk and to free up capital for further lending.

The investments are known as “asset backed securities” because the securities are “backed” by, and are repaid from, payments made on the loans (mortgages, car loans, corporate loans).

Europe has a good track record with securitisations, but there were some bad and overly complex structures that contributed to the great financial crisis. Many regulations have been enacted to prevent the misuse of the securitisation technique. For example, regulations mandate that those creating the loans (originators) keep 5% of the risk of the loans (“skin-in-the-game”) to make them take care over the long-term performance of their loans.

The following document explains in more detail how securitisation contributes to risk management and investment benefits, with some specific examples.

Issuer Considerations

Funding Diversification

It is a well-established and accepted practice that financial institutions should pursue a strategy of risk diversification, both on the asset side as well as the liability side. Prudent banks should raise funds and capital from a variety of sources, including deposits, senior unsecured debt, subordinated debt, covered bonds and securitisation. The benefit of this strategy has been proven on many occasions. For example, during the sovereign crisis in Europe in 2012–13, many investors shunned senior unsecured and covered bond investments because of the perceived correlation between sovereigns and the banking sector. Despite being shut out of the senior unsecured and covered bond market at that time, Santander UK was able to raise over £15 billion of funding from its securitisation programmes, demonstrating the strategic importance of this funding tool.

Risk Reduction

Securitisation has a unique benefit compared to other capital market instruments: the ability to share risk originated by banks and other originators in their ordinary course of business with institutional investors. As the term “asset-backed” describes, a securitisation represents a transfer of assets to a ring-fenced issuing vehicle which issues securities “backed” by the transferred assets. Some of these securities are sold to institutional investors and others are retained by the originator to assure alignment of interests between originators and investors. Investors in these instruments have no recourse to the originator of the assets, resulting in the transfer of the majority of the risk of the assets to institutional investors. Similarly, risk sharing transactions (synthetic securitisations) result in sharing credit risk of a designated pool of core and healthy assets via credit default swaps or guarantees with investors outside the banking system. This allows banks to free up capital for recycling into additional lending and contributes to a stable and sustainable financial system.

Investor Considerations

Portfolio Diversification

As in the case of issuers, investors also seek diversification of investments for the benefit of their clients. In the case of APG and PGGM, these investments are attractive hold-to-maturity assets which help support pensions for 7 million employees in the government, education and health care sectors in the Netherlands. Securitisations offer investors stable, high quality investments with unique exposures and attractive risk-return profiles when compared to other asset classes such as sovereigns, corporates or even covered bonds. The tranching nature of securitisations

also provides investors diversification in terms of risk-return, allowing them to purchase various tranches that appeal to funds with differing investment objectives. While APG and PGGM are mainly buy-to-hold investors, the conversion of basically illiquid banking assets into tradeable capital market instruments could also give investors the opportunity to on-sell the securities to obtain liquidity.

Risk Sharing

Securitisation is an attractive and cost-efficient way for institutional investors to gain exposure to real economy consumer and corporate assets, especially as many of such exposures cannot be found elsewhere. Investors may gain this exposure without having to develop in-house origination and servicing capabilities. They benefit from the servicing expertise of originators, which maximises the value of the portfolio. Risk retention requirements, by regulation or by investor requirement, also reinforce the policy of investors to invest alongside the originating banks in order to assure alignment of interests.

Society Considerations

Abuse of the securitisation technique by certain parties has contributed to the great financial crisis. If handled correctly and in a responsible way, securitisation as a technique can provide significant benefits to society and the real economy. As an analogy, automobiles, when misused by their drivers, can cause great destruction and death. Society does not argue for the abolition of automobiles in order to avoid such negative effects, but rather promotes driver education and strict traffic rules enforced by police. Similarly, securitisation should not be abolished because of misuse by some industry participants. Rather we should promote and enforce the safe use of securitisation as intended by the STS regulation.

Securitisations provide significant benefits to society:

1. Funding the real economy: securitisation can be an attractive funding source for banks to support their lending activities.
2. Recycling capital for further lending to the real economy: the risk sharing/capital relief benefits of securitisation allow banks to recycle capital into further lending. This could benefit (thousands of) European SME companies.
3. Supporting the environment: project finance securitisations support the environment by channelling investor money into renewable energy and infrastructure projects, which enhances Europe’s transition to a low carbon society.

The three points mentioned above are illustrated by the following four case studies.

Case Studies

1. Funding the real economy

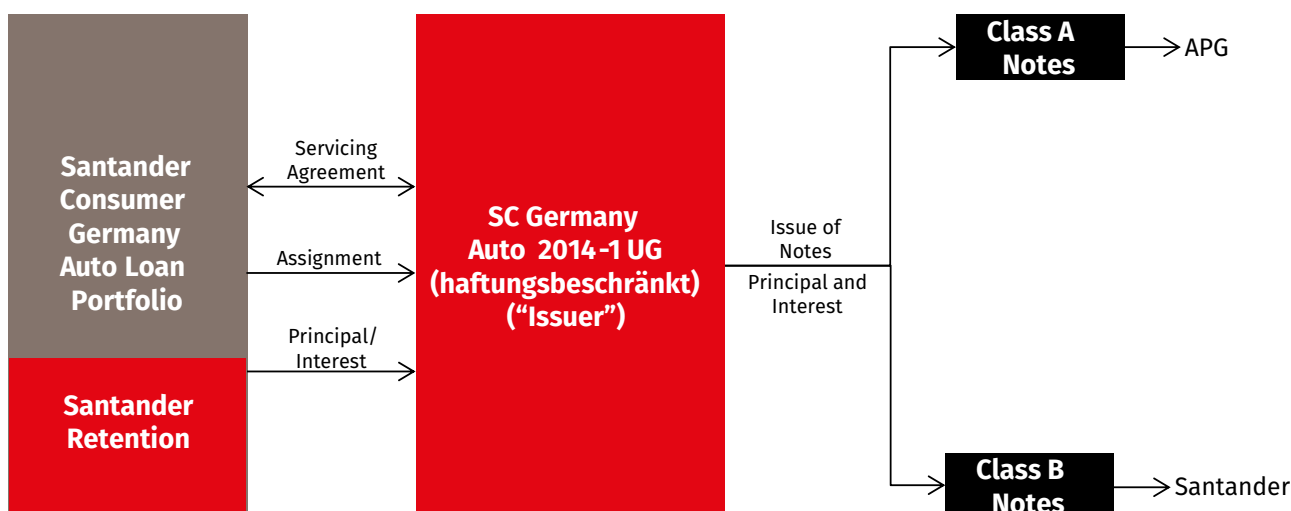
Santander's consumer finance subsidiary, Santander Consumer, uses securitisation as a valuable funding tool. Santander has a corporate objective for its principal subsidiaries to obtain financing independent of the parent company. Securitisation is the optimal way to achieve this goal, as it currently provides Santander Consumer's various European subsidiaries, most of which do not have an independent rating, access to a large and low cost investor market. In some of our smaller affiliates, securitisation has provided the only access to the capital markets. In other affiliates, securitisation provides an attractive alternate source of funding as part of a prudent plan to diversify their funding sources. Santander Consumer has successfully tapped the securitisation market in Spain, Portugal, Italy, France, UK, Poland, Austria, Netherlands, Norway, Sweden, Finland and Denmark for almost 20 years, such as the case of Santander Consumer Germany.

In the example below, Santander Consumer Germany securitised a € 600 million pool of auto loans the company originated as part of its core business, by selling the pool to SC Germany Auto 2014-1 UG, a special purpose vehicle. The SPV then issued a senior Class A note, and a subordinated Class B note, backed by the transferred auto loans. APG and other institutional investors purchased the Class A notes and Santander retained the subordinated Class B notes in fulfilment of its obligation under Article 406 to retain "skin in the game", thereby aligning interests between Santander and investors.

Access to this valuable funding market has enabled Santander Consumer to provide competitive and attractive financing for consumers throughout Europe in greater quantities than would have been possible without access to this market. The benefit to the European economy is therefore evident.

APG's active involvement as an investor in many of Santander Consumer's auto loan securitisations has given them alternative investments with an attractive risk-return profile, which are more exposed to "consumer" credit risk than to "corporate" or "sovereign" credit risk that is more present in the traditional credit investments.

SC Germany Auto 2014-1 UG Consumer 2015-1 UG Auto Loan Securitisation





2.a Recycling capital for further lending to real economy

Santander also uses securitisation to share the risks of its loan portfolios with institutional investors, thereby achieving SRT (Significant Risk Transfer) and allowing us to reduce risk weighted assets and free up capital for further lending.

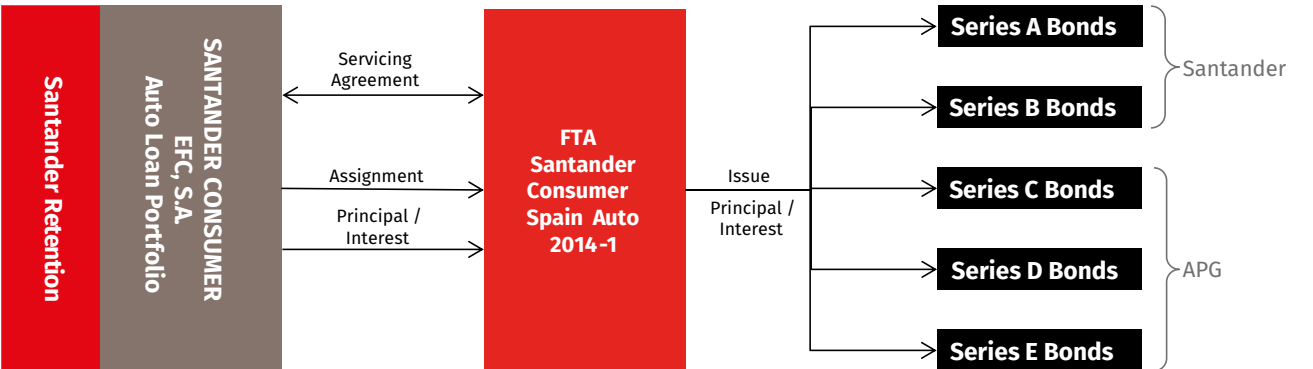
In the example below, Santander securitised a € 760 million prime auto loan portfolio originated by Santander Consumer’s Spain unit which was originally closed and retained by Santander in 2014.

In December 2015 Santander offered and sold the Class C, D and E subordinated securities to APG and other institutional investors for a total of € 67.6 million representing the first 9% of losses on the portfolio. Santander retained a vertical slice of the securities in compliance with Article 406 “skin in the game” regulations in order to assure alignment of interests.

The sale of the subordinated securities enabled Santander to achieve SRT at a lower cost than other alternatives, such as selling new shares.

For APG, the investment provides an attractive risk-return profile and gives APG exposure to the Spanish consumer loan market without having to invest in expensive origination and servicing infrastructure.

Santander Consumer Spain Auto Loan Securitisation SANCF 2014-1



2.b Recycling capital for further lending to real economy

Santander also makes use of synthetic securitisation to achieve SRT, such as the Victoria SME transaction closed with PGGM’s pension fund client, PFZW, in December 2015.

Using a simple CDS contract between PFZW and Santander, PFZW provided credit protection on 80% of a € 2.3 billion pool of SME loans to Spanish SME borrowers, originated by Santander in Spain. Santander retained 20% of the risk in each of the loans to assure alignment of interests.

PFZW collateralised its obligations under the CDS contract by depositing cash in the amount of the credit protection limit in a custodian account which invests in high quality sovereign bonds which mature on each interest payment date. This eliminates the counterparty risk that PFZW and Santander would be exposed to.

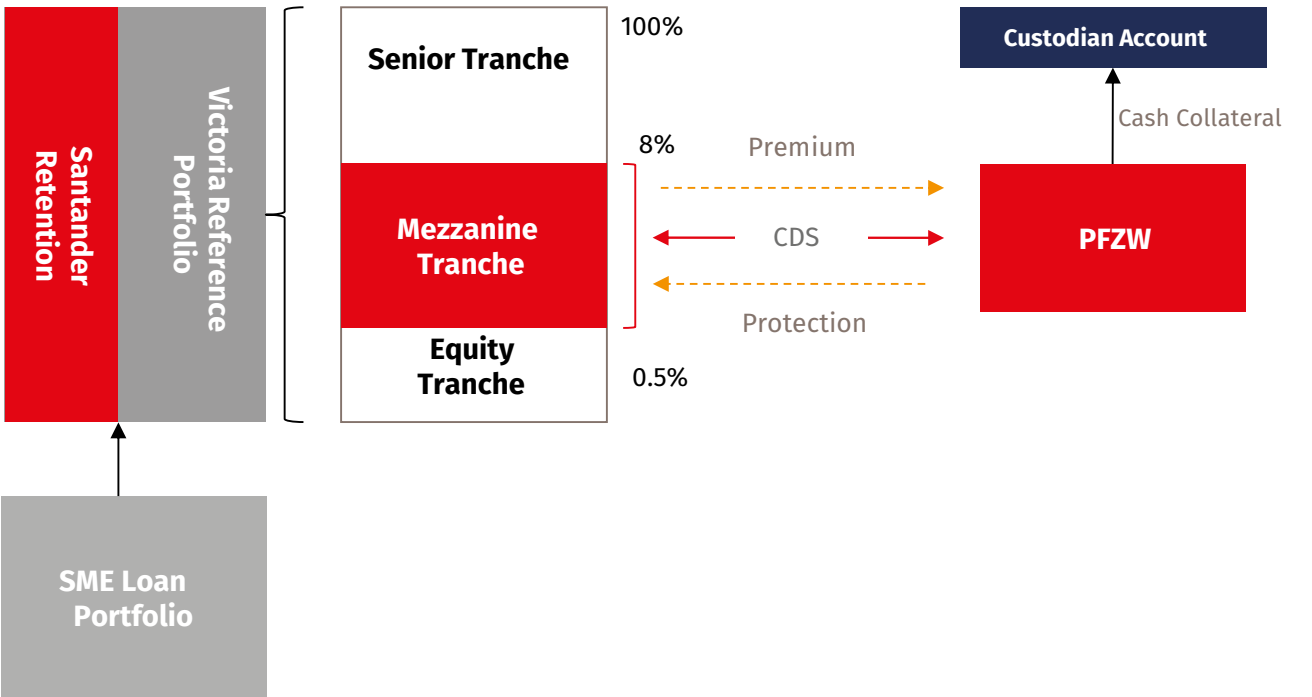
The CDS contract covers credit losses incurred on the SME portfolio once the losses are higher than 0.5% of € 2.3 billion (which is for the account of Santander), up to a limit of 8% of € 2.3 billion. The size of the protection was sufficient to cover expected and unexpected losses on the portfolio, thereby achieving

SRT. This enabled Santander to lower its risk weighted assets and to free up capital for further lending to the SME sector.

The risk sharing structure utilised was the optimal alternative for Santander for this asset class as a rated, traditional securitisation would be prohibitively expensive due to the conservative view of SME loans and the sovereign cap imposed by rating agencies. Also issuing new shares or otherwise raising additional capital would be more expensive than the cost of the Victoria transaction. Covered bonds are not an alternative for SME loans, and because of the dual recourse nature of covered bonds, it would be impossible to achieve SRT with a covered bond.

For PFZW, the investment provides an attractive risk-return profile and gives PFZW exposure to the Spanish SME loan market without having to invest in expensive origination and servicing infrastructure.

Victoria SME Risk Sharing Transaction



3. Supporting the environment

In this example Santander securitised € 850 million of long-term project finance loans originated by Santander throughout Europe. The deal closed in 2009 and is still in operation. The initial portfolio consisted of 60% Renewable Energy Projects and 24% Infrastructure Projects.

Santander purchased € 102 million of credit protection from PFZW. Boadilla 2009-1 is an SPV which entered into a CDS contract with Santander and which issued credit linked notes, representing the first 12% of losses on the portfolio. To eliminate the counterparty risk in the transaction, PFZW and Santander agreed to invest the cash in short-term high quality securities, which ensures complete and timely payment of credit losses for Santander. Santander retained 20% of the risk of each loan in the reference portfolio alongside PFZW in order to align interests.

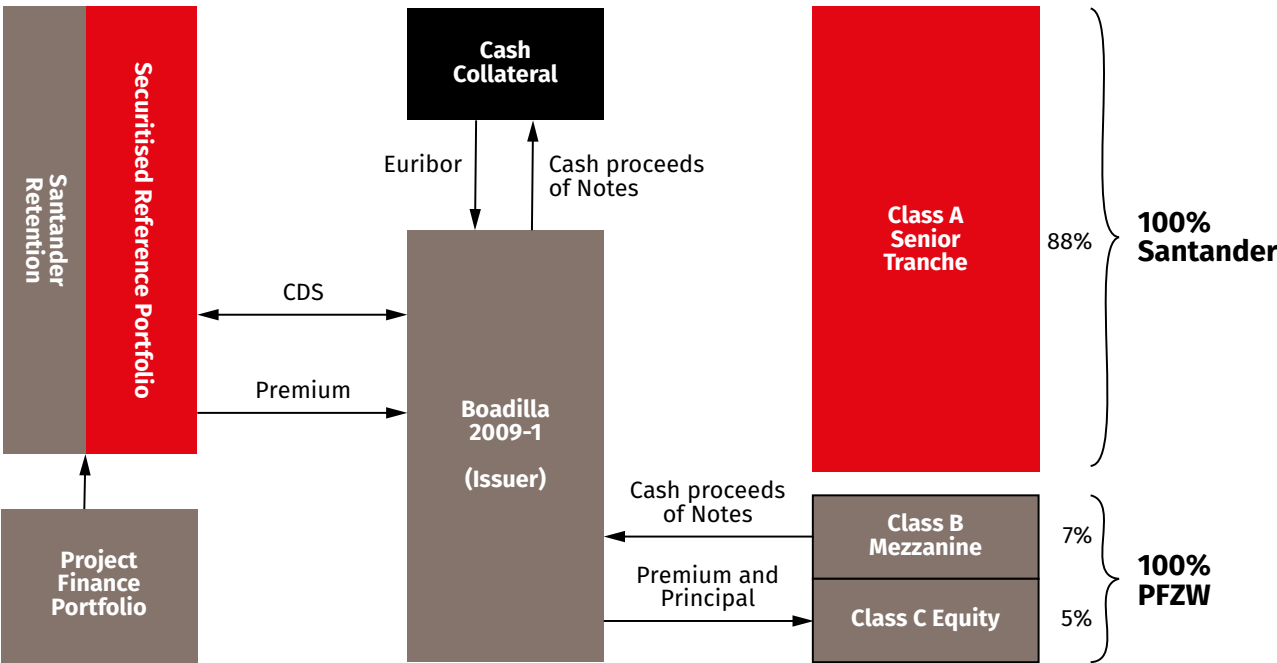
As in the case of Victoria, Santander transferred the credit risk of 80% of the portfolio, thereby freeing up lending capacity in the project finance sector.

PFZW gained long-term exposure to the European project finance sector, including wind and solar projects, helping PFZW to support green energy in Europe.



As in the case of Victoria, the risk sharing structure was the optimal choice for Santander, as restrictive lending clauses in the loans would have prevented Santander from selling many of the loans to an SPV in order to issue a traditional securitisation. The cost of the transaction was less than the alternative of issuing new shares or otherwise raising additional capital.

Boadilla 2009-1 Project Finance Risk Sharing Transaction



About APG

APG Asset Management N.V. is a Netherlands based asset manager that works exclusively for pension funds. We work for more than 20,000 employers and provide for the income of more than 4.5 million citizens in the Netherlands and manage over 30% of all collective pensions in the Netherlands. APG AM had assets under management of approximately € 417 billion as per March 2016. APG AM is an indirect subsidiary of Stichting Pensioenfond ABP, the Dutch pension fund for the government and education sector and the second largest pension fund globally.

Our clients, Stichting Pensioenfond ABP and several other major Dutch pension funds, are very large institutional investors, acting in the interest of pensioners. Pension funds can play an important role in fostering long-term investment and economic growth, due to the match between the long duration and maturities of their liabilities on the one hand, and long-term financing on the other.

About PGGM

PGGM is a leading pension fund service provider in The Netherlands for more than 2.6 million participants of different pension funds. We currently manage € 192 billion (March 31, 2016) of pension assets for a number of Dutch pension funds, including € 172 billion (March 31, 2016) 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. PFZW has given PGGM an exclusive mandate to invest up to 2.5% of their assets in risk sharing transactions such as the Victoria and Boadilla 2009-1 transactions mentioned in this paper.

About Santander

Santander Group is a diverse retail and commercial bank with 13,030 branches, over 193,000 employees and more than 120 million customers. Santander Group's geographic footprint is balanced between mature and emerging markets, with a significant presence in Argentina, Brazil, Chile, Spain, United States, Mexico, Poland, Portugal, United Kingdom and consumer finance business in Europe. The Bank has high market shares in retail and commercial banking in its core markets where its principal business is to attract deposits and provide loans. The Bank focuses its wholesale banking offer on providing services to its main customers in local markets.

Santander has a medium-low risk profile and high asset quality, with a risk management culture that strives to improve every day. It has a solid capital base consistent with its business model, balance sheet structure, risk profile and regulatory requirement. Our success comes from being close to our customers, its focus on retail and commercial banking and a sensible approach to lending. The relationship with our customers is long-standing and built on trust and confidence.



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Glossary

CDS	Credit Default Swap, a contract between two parties in which one party agrees to cover credit losses incurred by the other party.
SRT	Significant Risk Transfer, for a bank to claim capital relief for a securitisation of balance sheet assets, the regulator wants to see that a significant portion of the credit risk has been transferred to a third party.
Tranches	Slices of a securitised portfolio which have different rankings in terms of when the investors in the tranches will be affected by losses. A first loss tranche investor will be affected by the first x amount of losses; any additional losses will be absorbed by the investors in the second loss tranche and so on.
Mezzanine	An alternative name for the second loss tranche.
Equity	An alternative name for the first loss tranche.
True sale	Refers to the fact that the loans are sold by the bank to the securitisation vehicle in a legal true sale that effectively ring-fences the assets away from the bank.
Synthetic	Refers to the fact that loans are not sold to a securitisation vehicle but remain the property of the bank. The bank hedges the credit risk of the loans by entering into a CDS or financial guarantee with one or more investors, who agree to reimburse a portion of the credit losses on the loans.
Financial Guarantee	A contract in which one or more investors agree with a bank to reimburse losses suffered by a bank on a portfolio of loans as the result of credit events, such as failure to pay and bankruptcy.
SPV	Special Purpose Vehicle, a legal entity specifically set up for the securitisation transaction. In a true sale securitisation, the SPV purchases the loans from the bank and issues securities backed by the payments on the loans. In a synthetic securitisation, the SPV does not purchase the loans, but enters into a CDS or Financial Guarantee with the bank and it issues credit linked notes to investors who agree to reimburse losses suffered by the bank on the agreed (a referenced) portfolio of loans.
Principal	The actual amount of money the bank lends to a borrower.
Interest	The interest rate the borrower needs to pay on the loan.
Retention	The share of the loan portfolio the bank remains exposed to and which is not sold to or hedged by the investors.
Premium	The premium is the payment (like an insurance premium) that a bank pays investors to compensate them for taking a portion of the credit risk of the loans in a synthetic securitisation. The premium is calculated on the maximum amount of losses on the securitised loans the investors commit to reimburse.

Technique of Securitisation

Fund of loans

- All investors have equal ranking in terms of risk and return on the loans in the fund.
- The investors' return is all payments received on the loan portfolio, being interest payments and return of principal minus losses on loans that failed to repay.
- Investing in a share of a fund is equal to buying a 0–100% tranche of that loan portfolio.

Securitisation

- Investors have different ranking depending on which tranche they bought.
- Investors' risk and return differ per tranche, with more senior tranches having a lower risk and hence a lower return, and more junior (or subordinated) tranches having a higher risk and requiring therefore a higher return.
- Different tranches have different rankings in terms of when the investors in the tranches will be affected by losses. A first loss tranche investor will be affected by the first x amount of losses; any additional losses will be absorbed by the investors in the second loss tranche and so on. All investors in a single tranche have equal ranking with each other, but they will rank senior or junior to other tranches. If investors invest in a tranche that is described as 0%–10%, it means that investors in that tranche bear the first 10% of losses in the pool of loans. If investors invest in a tranche that is described as 60%–100%, it means that those investors will only absorb any losses in the pool of loans that exceed 60% of the value of the pool of loans.

- True sale: all payments received on the loan portfolio, being interest payments and return of principal minus losses on loans that failed to repay, are used to pay the tranche investors, starting with the most senior tranche first, then the next ranking tranche (the mezzanine tranches), then the next ranking tranches (the junior or equity tranches). If the loan portfolio experiences no losses, all investors will receive all the principal and interest payable on that tranche. If there are some losses in the portfolio, the most junior tranche will absorb the losses first, then the mezzanine tranches, then finally the senior tranche.
- Risk Sharing Transaction/Synthetic Securitisation: like a true sale securitisation, investors invest in different tranches that represent different allocations of losses on the securitised portfolio of loans. Typically, the investors buy the junior tranches (first loss, second loss) and the bank holds (retains) the senior tranche. The bank pays a pre-agreed premium to the investors to compensate them for hedging the risk of credit losses of the reference portfolio of loans up to the limit of the tranche and in accordance with the ranking of that tranche as described above. The actual cash flows from the loans (interest payments and principal repayments) stay with the bank.

Securitisations

