James Parsons

Episode 224: Insurance Insights The Synthetic Risk Transfer Opportunity - Part 1

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name is Stewart Foley, I'll be your host. Welcome back. It's nice to have you. I'm really happy that we have the insurance investment community as our audience because as I always say, this is the world's smartest money, and that's predominantly due to the externalities that insurance investors have to navigate that most other institutional investor types don't. And I think that one of the things that's interesting over the last several years in particular is the number of innovative strategies that have been brought to the forefront here that are a good fit for insurance investors. And so today is one of those differentiated strategies, that I think that you'll find interesting. And we're joined today by James Parsons, who's a partner at PAG, senior portfolio manager of credit and markets, lead portfolio manager of the PAG Bank Risk Sharing Strategy. James, thank you for being on. Welcome. How are you today?

James: I'm very well. We've got a nice sunny day. I'm located in London and it's not often we have sun here, so I'm very happy and it's a great pleasure to be on the podcast today.

Stewart: Well, we're thrilled to have you and we just relocated to just outside of Austin, Texas where there is no shortage of sunshine and the temperature is starting to climb into the nineties and everyone is telling me just wait, so I can relate to the sunshine for sure. And you've got a very rich history and background in this market. But before we get there, I want to start this one the way we always do, which is what's the town you grew up in? What was your first job? Not the fancy one. And what makes insurance asset management so cool?

James: Wow, good questions. So I am British. I grew up in a little village in southern England, and that meant my first job of any type was a summer job baling hay, in the fields. That's where I started, a long way from insurance investment management. I had a career as a banker and through that, out the other side in fund management. I have to say I grew up... I mean, nobody I think grows up thinking they're going to be involved in bank regulatory capital, which is what I'm deep in the weeds of, but here we are, that's how things ended up.

Stewart: And so what do you like about working with insurance companies? I mean, it's interesting that you do have a deep background in regulatory capital outside of insurance which makes you particularly well-suited to deal with the rapidly changing regulatory environment that our insurance investor audience is dealing with right now.

James: Yeah, it's an interesting point that, because there are almost two parallel track regulatory capital regimes, one for banks, and that's been changing very significantly, particularly since 2008/09 since the GFC. And then of course for insurers as well. Slightly different challenges and so different regulatory capital regimes, but ultimately both aimed at safety and soundness. And I think what the banks do particularly in terms of investment grade lending is a great fit with some of the objectives for the insurance business.

Stewart: And I want to say also, that this is the first time we're chatting with the PAG platform. And for those who aren't familiar, it would be helpful if you'd mind sharing a little bit about who PAG is, and what brought you to the firm.

James: So PAG, we're one of the leading Asia-focused alternative managers. We've been investing in Asia in particular for more than 20 years. We manage around $55 billion worth of investor capital. And our clients we invest on behalf of are all major global institutional investors, including insurers. So, we like to see ourselves as their partner for Asia. We've got three main businesses in the firm. We have a private equity business which focuses on buyout deals across

developed Asia. We have a real assets business that has its roots originally in Japan real estate, but it now has more than 150 people across the Asia region. And we have dedicated teams in data centers and renewables. And then the third leg is credit and markets. So amongst other things, we are about the third-largest real estate private debt manager in the world and the number one in Asia. And my strategy, what we call Bank Risk Sharing, there are a lot of different names for this in the market, we'll come to it, but SRT strategy sits in credit and markets and I'm a little bit unusual in that I sit in London, so we have a reasonably sized London office and we run this as a global strategy out of London.

Stewart: I'm glad that you brought up this bank risk-sharing strategy. And it does go by different names. And you mentioned SRT, which I think, but you're going to tell me, I think stands for synthetic risk transfer. But tell me about what that means, and as with as big a crayon as you can, what is bank risk sharing strategy?

James: So it all relates to bank regulatory capital. So banks have been under increasing regulatory capital requirements since Lehman's collapse, essentially. So the GFC demonstrated to regulators in particular that the previous regime of minimum capital ratios for banks was too lenient. Capital, roughly 8% total minimum capital, was too low, because many banks became insolvent and, of course, taxpayer-funded bailouts had to take place and that's deeply unpopular and unsatisfactory.

So post-GFC, the regulatory authorities around the world have more or less doubled bank minimum regulatory capital requirements. That has kicked off two major developments I think in financial markets. The first has been the explosive growth of direct lending and private credit that really started give or take around 2013 in terms of the ramp up in growth. And the other is the growth in SRT.

So SRT is a way for banks to reduce their capital requirements on specific loan portfolios that they hold on their balance sheet. This mechanism has been available to banks since 2008, which was when the regulatory Basel 2 Accord came into place. But it really started its growth similarly to the private credit market direct lending. It started its growth at around 2013 and what it does is banks or the regulators permit banks to reduce the capital they need on specific loan portfolios if they buy credit protection from a non-bank source.

It's quite important it's a non-bank source because this is the bank regulators thinking about banks and systemic risk to economies. So generally speaking, there's a formula in the regulatory framework where they generally speaking require a bank to purchase credit protection on an amount of portfolio of up to maybe 10% of the total amount of the portfolio. So if there were losses due to credit events up to 10%, and that's where it would be capped out of the total portfolio amount, they would be covered by a non-bank investor.

So the loans themselves don't leave the bank's balance sheet. And the bank gets very significant capital relief from the regulators if they do this. So the word synthetic is there because the arrangement is contractual rather than an actual transfer of the loan, so in that sense it's a synthetic transfer of credit risk. There's too many terms for this. So you'll also hear just reg cap transaction for regulatory capital transaction, because the driver is regulatory capital relief. You'll hear, particularly in the US CRT for credit risk transfer, it's pretty much all the same thing. And then you might hear, this is a regulator's preferred term, SRT as standing for significant risk transfer. Now that word ‘significant’ doesn't mean a lot. It means a non-negligible amount of risk transfer in relation to whatever the risk of the portfolio is. It's like the scientific use of the word significant. Significant as opposed to negligible.

Stewart: I think our best podcasts are where we're absolutely teaching and I think that a lot of folks use our podcast to educate themselves on particular things. And you're doing an amazing job of... I mean, I understand this better than I ever have and it's thanks to that explanation. That's awesome. How big is this market and what opportunities does it create?

James: So current market is, in terms of outstanding investable product is about $100 billion. New issuance by banks is of the order of $20 to $25 billion per annum. And average transaction maturity is about four years. This market is… the existing stock rolls forward and there's additional new issuance every year. We've seen it growing for the last five years or so at about 20% per annum in terms of new annual volumes. But we're quite likely at a significant inflection point in the growth rate. Could be 30%, 40%, even 50% per annum in the years ahead.

And again, that's driven by regulation. So that's Basel 4. So that is an interesting one. The banks like to call it Basel 4. The US, regulators have called it Basel 3 End Game. In Europe, they call it Basel 3.1. There's a difference of opinion here because the banks say Basel 4 is a very significant further increase in capital requirements. The regulators say no, it was always intended when the original Basel 3 was published, which was back in 2013. But it's going to have a big impact on the SRT market.

Stewart: And is that what's driving this market right now and is there an equivalent market like this anywhere else other than with the bank regulatory capital as a result of Basel four?

James: Yes. Yeah, it's a common pressure across all the banks that have adopted the Basel capital Accords. And it's probably worth saying something about how that comes about. So the Basel capital accords come from the Basel Capital Committee and that's a gathering of central banks of what was originally the G 10 countries. It's now grown actually to 28 member countries. But they decided right back in the 1980s in order to promote banking stability, that they wanted to have a common set of rules for minimum capital requirements for banks. And they wanted that so that the banks don't over lever themselves and put themselves at risk of insolvency because clearly that's pretty bad for depositors, for companies, bad for economies. So they wanted to have a minimum capital ratio and a definition of what counts as capital so that there was transparency around what that capital ratio meant.

It was implemented in 1988, it is now called Basel one, and it was a pretty straightforward bit of legislation. It was quite simple and it was a huge success. It was adopted by over a hundred countries, even though it was only designed for the G 10 and it was just 30 pages of text. But because it was fairly simple, it created some unintended consequences. And one of those was due to the very simple rules that determine for a bank how risky each of its loans were for capital purposes. So it was how the banks should divide up the loans on their balance sheet into different risk buckets. So they had different capital requirements for each risk buckets that your loans could be classified in, but it was a very blunt system. So for instance, there was only one risk bucket for corporate loans. And it didn't matter how actually risky your corporate loans were, they all fell into the same risk bucket, so they had the same capital requirement. So what that means for a bank is that since you're going to be paid more if you lend to a riskier corporate borrower than you'll be paid by a less risky corporate borrower, but your capital requirement is going to be the same in both cases. You're going to earn a higher return on capital if you go riskier.

Stewart: And that would be what would be referred to as unintended consequences, right?

James: Indeed. Yeah.

Stewart: Or be careful what you incent.

James: Yes. And to give the regulators credit, they spotted this fairly quickly. They could see they'd created this wrong-way consequence, and they wanted to introduce more risk sensitivity within the broader buckets. The broader buckets are sovereign lending, corporate lending, lending to banks. And they originally proposed they do that with external ratings until somebody pointed out that of the entire borrower universe in credit, maybe 5% at most is rated. As soon as you get into mid-market, SME, you name it, there's no ratings.

And they instead adopted the model that banks were developing at the time, which is banks were using... And particularly the big banks, had developed their own internal rating systems and they collected data on the loss rates for each of their credit ratings, the losses they were actually... The defaults they were actually experiencing and the recoveries, so the net losses. And they were using that to estimate how much economic capital they should have against the potential for loss. And the Basel committee permitted the big banks to adopt that to calculate regulatory capital. So, it's really a bank's own estimate, with governance from the Basel committee, with a formula provided by the Basel committee, but using their own data.

Stewart: That's very helpful. And so in every investment there's some risk that the investor is taking, and being compensated by their return. And so when I taught finance, I would always say risk and return are inextricably linked. And it goes back to the point that you just made, which is lending to riskier borrowers means higher interest rates, and that's better for me until it's not. What is the risk here in these transactions that investors are being compensated for?

James: So you are writing credit protection on a specific loan portfolio held by the bank, and you are being paid a fixed coupon by the bank in consideration for writing that credit protection. And that coupon currently, depending on portfolio type, and we'll come back to that, ranges between 7% and 12%. The tenor of these transactions is broadly the maturity of the portfolio. So it's anywhere between 3 and 7 years, again, depending on what loan portfolio profile you are writing the protection on. And in these transactions, you have to put up cash collateral for the possibility that there will be credit losses that you need to make good.

That's so that the bank is not taking counterparty risk on the writer of protection. So they don't have to put capital against the counterparty risk. Which would make the transaction significantly less efficient from the bank's perspective. So when

I'm doing one of these transactions, I'm looking at a portfolio that I've chosen the loan portfolio type, and I'm looking at all the individual loans in the portfolio and saying, am I being paid enough premium over the life for the risk that there may be losses that I'll have to make good on that portfolio.

And broadly speaking, because I'm earning SOFR… so the cash collateral I put up is put on deposit, I'm earning SOFR on that in dollars for instance, and I'm earning somewhere between 7% and 12%. So if I'm paid 14% all in if I add the coupon to SOFR, say over 5 years, I've got 70 points of income compared to the nominal amount, my maximum liability for credit losses. So I'm saying how much credit losses might I incur and am I going to keep all that 70 points or might that be eroded by losses to 60 points or 50 points? And what's my return going to be and what would happen in a hard downturn? Might that then become 30 points left?

Stewart: It sounds like a bespoke version of a credit default swap. Is that fair? Is it comparable?

James: Yes, that's very fair, actually. Spot on, in fact. So credit default swap on a portfolio of loans rather than on an individual name, on an individual borrower. And when the market started, the credit protection was written as CDS. Outside of the US, it's now generally written as a financial guarantee for accounting reasons. But the financial guarantee terms look very similar to a classic CDS.

Stewart: Is that what PAG is doing, is underwriting the loan portfolio and seeing if you are interested in that particular SRT transaction. Is that the investment decision being made?

James: Exactly. And this is where it gets really interesting, at least from my perspective, is you have a choice here between what sort of loan portfolio you'd be interested to do this in. So if we go from the riskiest end down the risk scale to the least risky, you could do this on the risky end, you could pick a portfolio of leveraged loans, or you could pick a portfolio of unsecured SME companies. Small companies, just cashflow-based.

Stewart: Just for the record, what's SME stand for?

James: Sorry, small and medium-sized enterprise. In some countries this could be real mom-and-pop businesses.

Stewart: Got it.

James: You could take some sub IG, double B, maybe even single B names if that was your risk appetite. And then as you go further down the risk scale, well further up the risk scale. And if we're going to safer, there's a variety of interesting asset backed loan types that banks do that have very low loss rates because they've got the security over physical collateral, and then you've got things like subscription line finance, so the loans that banks make to private equity funds backed by the uncalled capital commitments to the LPs, a product that has an almost totally unblemished performance history.

So you have a choice, you can decide which ones you want to go for. You are clearly going to be paid a higher coupon up the riskier end, but you've got a higher chance of losses and you are more vulnerable to downside if there is a recession or hard recession, or you can go to the safer stuff, lower coupon, but higher certainty of return. I think you can probably guess what we do. We're down the lower risk end because we think the risk adjusted return is better there.

Stewart: That's really interesting. And it takes me back to GFC, right? When the GFC... And this is kind of funny because when I taught I would be like, "Oh yeah, back in da, da, da..." And it's like you forget that the students, they were like seven. So the GFC wasn't as big an event to them as it was to me and my career at that time. At the time when capital was being handed out by the government, there were some banks that said, "No, thank you." And the government said... I'm paraphrasing. the government said, "Hey listen, we need everybody to take capital because we don't want to out the people who are at risk. So everybody needs to take it." And which leads me to this, do these SRT transactions give you insight into banks' capital position? Are there any implications there that we can draw from participants in the market?

James: That's a great question. So we follow two things very closely. One is the bank capital regulations themselves. And I'd said earlier that Basel 1 was 30 pages. I live... It's about a 50-minute train ride for me to get home. I could have read that easily on the way home. Basel 4 or Basel 3 End Game as published by the Basel committee runs to 1,879 pages.

Stewart: So that's at least two train rides.

James: I'm not sure I'd finish it on a plane to Sydney, Australia. And that's without the annexes and the technical standards and so on. So a few things have happened. The idea, as I said, of the Basel committee was they'd create a level playing field amongst banks and common standards, and that promotes banking stability. As it's got longer and longer and more and more complex, the temptation for countries to implement it differently… because what the Basel committee publishes is the central bankers' views on what would be an appropriate framework that everybody should adopt. It's not law. And depending on which jurisdiction, it either has to go through parliament, that happens in the EU, or the local regulator has the authority to implement. Nowadays, pretty much everyone is saying, "Well, I've got special situations, special case, I want to tweak this, I want to do it a bit differently."

So you follow the regs very carefully in each jurisdiction, and then you look at a bank and what its capital position is just simply quarterly earnings reports and so on. Obviously you get more detail for year end. What its capital position is, what its strategy is, where it's focusing its lending activities. And there's a very interesting intersection between the two, which will drive banks' motivation for doing SRT. So the most common one is some lending products that banks want to be engaged in or feel they need to be engaged in, so for instance, revolving credit facilities to large corporates have pretty high capital charge through regulations in most jurisdictions, pretty high capital charge compared to the actual risk.

But they don't pay the banks that much because they're low risk products. So the bank's return on capital is pretty weak from things like large corporate revolvers. They've got to be in them, because big multinationals expect their banks to support their revolvers in order for the bank to get a foot in the door to be able to sell other more remunerative business from the bank's perspective. So what do they do with that? They can come to SRT, reduce their capital requirement, and when you work through the math of it, they broadly pay away around two-thirds of the income that they are earning on the revolvers. But they end up with... So they're retaining a third of the income, but they end up with just a sixth of the capital requirement.

Stewart: And that makes good sense from a return on risk-adjusted capital basis.

James: Exactly. They've doubled their return on capital.

Stewart: Which is exactly the same equation that insurance investors are trying to optimize, right? It's the return on risk-adjusted capital, which I think would resonate with our audience very well. From your seat, how are the banks doing at this point in the cycle? And are there portfolio types that you're concerned about as we record this on the 10th day of May 2024?

James: Generally speaking, I think the majority of banks are in pretty good shape. There are some quite well-flagged selective instances of banks in a more precarious position. I think it's particularly those with high exposure to commercial real estate or longer-dated fixed rate bonds. But outside of that, and that's really... as has been well-documented, some US regional banks, some German mid-sized banks that specialize in real estate. There are a couple of problem areas, but if you look across banking more generally, post-GFC regulation and bank supervision tightened very significantly, particularly for the large banks. And the big banks are now pretty well capitalized, conservative balance sheets, tight underwriting standards, and we've seen very little deterioration or even negative credit migration.

So they're in pretty good shape. But where we start to see the pressure is in the more levered borrowers. Rates high for longer does put more pressure on the more levered names, and the longer the rates stay at these kind of levels, the more pressure that's going to be. So that's I think a real concern.

Stewart: I have gotten such a great education on synthetic risk transfer and banking regulation and what's going on. I really appreciate you being on. It's been a great educational experience for me. And I've got a couple of fun ones for you out the door, if you'll indulge me. Many of our guests answer both of these. You don't have to, but no pressure. I'm kidding.

And people can't see the video, but you and I have both... By the looks of us, we've both been in this business for a minute. So is there a piece of advice along the way that you would give a 25-year-old James Parsons today, as you look out at the opportunity set for people who are early in a career in finance? Is there anything that you would tell them or a nugget that you would share with them that you think would be helpful?

James: Yes. I think there's two things. So more recently in my career, as a manager of people the thing that I really value the most in people in my team is integrity and reliability. You can be smart, but if you don't have high integrity and reliability it's very hard for people to use you and help you to advance in the way that you would probably like. And that reliability thing sometimes goes missing. So that's kind of one thing. Most people in this business or everybody is

technically competent. So that's what distinguishes in my view. The other thing when I look back is really just how fast the world has changed.

Stewart: It has.

James: It changes faster and faster. And I think it's not only in the obvious areas like technology and geopolitics and these kind of areas, it's also the way people think about things. And investment management is about money and capital value and so on. And that's ultimately a social construction. And how people think about that really matters from the point of view of navigating financial markets. So an acute awareness of how things are changing would be my other sort of top tip to keep an eye on.

Stewart: Shout out to our good friend Betsy Ziegler, who's the CEO of 1871. She's actually going to be the closing keynote speaker at our event in June. And the first time I heard her speak, she said, "Today is the slowest pace of change you're going to face for the rest of your life." And I thought that was so insightful and so true. And to your point, my career dates back to floppy drives, no hard disks, no email, no internet. No BlackBerry, no wireless email. We had 15-column accounting worksheets that came in a big tablet. And we used pencils and a 10-key calculator.

And it's like, I feel like... I say that to people and I feel like Father time, and my students would be like, "Tell us another story, grandpa." But you're right. It has changed a great deal, and I agree with you wholeheartedly. The pace of change is only going to increase, particularly with the advances in AI that are here. But before I go too far here, I want to ask you my final fun question, which is, who would you like to have lunch with, alive or dead? Now you can have up to a table of... You can invite three people. It can be you and a table of four, or you can just ask one person, but who would you like to have lunch with, alive or dead?

James: So yeah, I'd probably invite three people. I think my first would be a guy called Carlo Rovelli. He's a physicist who's written some...still alive. He's alive and well. He's written some really excellent popular science books on modern physics. And I'd have a ton of questions for him if he had the patience to answer them. I'd love to meet a guy called Steve Toltz. He's an Australian novelist. He published his first book, I think it was back in 2008. It's called A Fraction of the Whole. I read it three times and I'll read it again at some point. It's a comic novel about the progression of a family that starts in Australia, but he explores all the absurdities and contradictions of life.

It's almost a philosophical comic novel. I think he'd be a fascinating conversationalist, but I'd also like to understand how did he write such a book? How does his mind work that he wrote that book? And then I think invite... I've got one more. I think it's probably Lana Del Rey, the US singer. So I'm a very mediocre amateur guitar player and an even worse songwriter. And she was taught to play guitar by her uncle as I understand it. And she said as she learned to play, she said, "I could probably write a million songs with those six chords." And I just love that statement. I can sort of see where it's coming from and I'd love to learn from a master, which she clearly is in the songwriting craft.

Stewart: Wow, that's fantastic. I've really enjoyed having you on. I really appreciate it. Thanks for taking the time with us, James, and you're welcome back anytime.

James: Thank you. It's been a great pleasure. Really enjoyed it.

Stewart: We've been joined today by James Parsons, partner at PAG, senior portfolio manager of credit and markets, lead portfolio manager of PAG Bank Risk Sharing Strategy. Thanks for listening. If you have ideas for a podcast, please email me. It's stewart@insuranceaum.com. You can rate us like us and review us on Apple Podcast, Spotify, Google Play, Amazon Stitcher, Twitter, or whatever you get your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com Podcast.