Information Management Network

EXCLUSIVE INTERVIEW WITH

JAMES PARSONS

Partner

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In the exclusive interview below, the IMN team interviewed James Parsons, Partner at PAG. Read on as James shares his expert opinion on developments in the SRT market, synthetic SRT performance, the impact of Covid-19 on the industry, and more.

HOW ARE YOU CURRENTLY INVOLVED IN THE SRT MARKET?

I manage the SRT investment strategy at PAG, a $40bn alternative investment manager.

HOW LONG HAVE YOU BEEN AN INVESTOR IN SRT TRANSACTIONS?

I have been managing SRT investments for 14 years now. I ran BlueCrest Capital's SRT investment fund from 2007 until 2016, and then joined PAG in 2017.

HOW HAS THE SYNTHETIC SRT MARKET DEVELOPED OVER THAT PERIOD?

The synthetic SRT market has closely followed the regulatory developments in European bank capital. The first Basel II synthetic SRT deals, in which equity tranches were sold to investors, were executed in the second half of 2007 in anticipation of the implementation of Basel II on 1st January 2008. The GFC in 2008/9 then put an effective halt to the market until primary business resumed in 2010. New transaction volumes were low however until 2013, when primary issuance started to pick up.

2013 was the year in which the higher capital ratios required under Basel III were finally confirmed, with full implementation due on 1st January 2019. Whilst European banks had been steadily increasing their capital ratios following the GFC, they now had more certainty regarding the regulatory figure they were aiming for. Also, in 2013 the ECB announced that it would like to see increased use of securitisation by banks as a tool to help increase lending, especially to SMEs. This was the start of a number of initiatives at both the ECB and the European Commission, which subsequently led to the publication of the EU Securitisation Regulation in 2017, for implementation from 1st January 2019. Only a small number of banks had been active in the synthetic SRT market between the GFC and 2013, however after these developments the breadth of bank issuers steadily increased. Today most major European banks have issued synthetic SRT transactions and consider the technique an important part of their toolkit for balance sheet management.

As synthetic SRT issuance has increased, it has attracted more investors to the market, particularly over the last 2 to 3 years, which in turn has also encouraged more issuance in what could be considered a virtuous circle for the market.

Additionally, the technical requirements of a synthetic SRT transaction are now well established, so although there is still important detail to be addressed in transactions and a degree of tailoring may be required, execution processes have generally become more efficient over time. The basic synthetic SRT structure is now being used across a wide range of underlying portfolio types, as well as to achieve a broader range of objectives, not only the original aim of reduction in risk weighted assets, but also for increasing return on capital, managing IFRS9 transitions, and for overall risk limit management.

HOW HAS THE SYNTHETIC SRT MARKET PERFORMED?

There is no central repository of information on synthetic SRT transactions and many are done on a bilateral basis between a bank and a single investor, so it is not possible to confirm performance across the whole market. There have been a few specific transactions that I am aware of that have not performed particularly well for investors, however I think it is fair to say that these have been fairly idiosyncratic situations and the relevant transactions are not particularly representative of the mainstream synthetic SRT market. Overall, the performance of synthetic SRT transactions has been generally good throughout the market's post Basel-II history. The International Association of Credit Portfolio Managers (IACPM) has also compiled data that supports this assertion.

I would however observe that the market has perhaps not yet been truly tested. Central banks have been in control of financial markets since quantitative easing started in 2008, and central bank support has kept financial conditions broadly benign since then. Having said that, when for instance one looks at large corporate portfolio synthetic SRT transactions in 2020, whilst the immediate stress was relatively short-lived, thanks once again to central bank intervention, during the time of stressed conditions all of the valuable attributes of SRT for banks kicked in, including risk weight asset relief at a time when risk weights were increasing across the balance sheet, protection from higher expected loss, and an economic hedge.

WILL THE COVID-19 PANDEMIC HAVE ANY LASTING EFFECTS ON THE SYNTHETIC SRT MARKET?

I believe there are a few operational developments that are likely to endure. For instance, due diligence on new transactions has had to be completed by audio or video conference rather than in person. I expect that even once travel is permitted again, at least a part of due diligence will continue to be done this way. As another example, some banks have been very good at providing general conference call updates to their synthetic SRT investors on a regular basis since the start of the pandemic. This has been very well received by investors, strengthening their adherence to those banks, and I expect that the practice of providing periodic updates of this nature will continue even after the pandemic is over.

However, in my view the most profound and lasting impact is that the regulatory restrictions imposed on bank dividends and buybacks during the pandemic have accelerated the timeline for most banks reaching a 'steady state' capital condition. The Basel cycle of increasing capital requirements is now over, with no further material changes in regulatory capital rules likely beyond Basel IV. As Q4 2020 reporting has started to come in, it is evident that overall banks' CET1 ratios have actually increased in 2020, and that many banks are comfortably capitalised even taking Basel IV into account. Although dividends and buybacks are expected to resume later this year, they can be calibrated from a point at which long-term capital targets have been met, or even exceeded in some cases. Rather than needing to increase capital ratios, banks will instead be in a position to manage capital on a steady state basis between organic capital growth and distribution to shareholders.

I believe this takes the synthetic SRT market into a new phase, in which the primary objective of absolute reduction in risk weighted assets which guided the market's development in its earlier years is replaced with the use of synthetic SRT transactions primarily to increase return on capital. This is especially relevant in today's low interest rate environment which puts pressure on loan net interest margins. So although the market environment has evolved, thanks to its attributes banks' use of synthetic SRT transactions will continue to be a powerful tool to support lending to the real economy.