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Greensill: The lessons for credit insurers

What lessons should credit insurers take from the Greensill crisis? Igor Zaks, President at Tenzor sees a bright future for credit insurance as long as it continues to develop efficient safeguards and best practices.

The credit insurance industry is undergoing a critical transition. Initially mainly used to support corporate suppliers, it became more prominently used by bank lenders and now is used increasingly by various types of platforms. The ability to innovate, design new distribution channels, and reach new markets is vital to the growth of this long-established industry. However, as we all learned in 2008, the 'originate-to-distribute' approach has its inherent risks and needs multiple safeguards to work properly.

Greensill became an important case for two reasons: first, it became probably one of the largest 'non-traditional' insurance programmes, and second, it went badly wrong.

Prior lessons from the 2008 crisis

If anything, the 2008-9 global financial crisis (GFC) was a great example of the resilience of the credit insurance industry. Having mainly traditional whole turnover policies for corporate clients and significantly less extended banks (and cancellable limits), the industry quickly adjusted with only limited losses (this caused some reputational damage and reluctance to use the product among some financiers). By contrast, monoline insurers (like Ambac and MBIA) that offered unconditional cover suffered catastrophic losses. Trade receivable asset-backed commercial paper (ABCP) conduits had minimal use of credit insurance. The exceptions were ECA-backed conduits that performed OK credit-wise but would have to wind up after eventually being unable to place paper.

The Greensill story

The roots of Greensill's business model were probably in what Lex Greensill was doing at Morgan Stanley. It provided supply chain finance to investment-grade companies and then did private securitisations (that had to shut down during the 2008 crisis on the back of the inability to place securities). With Greensill Capital, the same evolution appears to have happened with ABCP conduits that started with short-term highly liquid assets and gradually increased the share of much higher risk and higher yielded assets. It seems Greensill also tried to build various assets (many of which were high risk and long duration and, therefore, attracted high yields and/or fees).


Igor Zaks

It also became a major user of credit insurance. The question was what was actually insured (there also seems to be a duration mismatch where funding was extended for periods longer than the insurance period). In addition, financing future receivables, some related party transactions, etc, raised many questions on the insurability of these risks. Critically, even today, what precisely was insured was not publicly disclosed despite many public inquiries and litigations.

Similar to the GFC, there seems to have been limited due diligence by the asset managers, and the assets considered low risk ended up with investors. In addition, the existence of insurance was marketed as some sort of 'stamp of approval' and created enormous 'arbitrage' opportunities (another similarity with 2008).

What does this mean for insurers?

New ways of distribution present a challenge to the insurers. The old way was that the supplier or financier had a policy (that was supposed to be carefully reviewed by their lawyers) and day-to-day communication with an insurer and a broker. This way, the insured should understand what was covered and what was not (and if the claim was ineligible,

it was often linked to an insured's specific actions). For banks, there was also regulatory pressure leading to ITFA sponsored work on standardising policy wordings to comply with Basel III regulations. Relevant divisions of the banks also accumulated experience dealing with insurers. Unfortunately, this did not apply to some of the other bank divisions, as the Greensill case shows).

With the originate-to-distribute model, the core problem is that the insured is often not a well established, creditworthy entity (as shown in the example of Greensill and some more minor cases before), so investors have significant exposure not mitigated by credit insurance. Such failures can potentially affect the perception of the product and its ability to grow (as, for example, Enron-related litigation between insurers and JP Morgan had a significant effect at the time). For the industry, there are a few ways to address the problem:

Ways insurers can address the problem

1. Removing most of the conditionality to the product, for instance, a monoline type of approach taken before the 2008 crisis. This is a very high-risk strategy with a potentially catastrophic impact on the industry, as the monoline example showed.

2. Improving transparency If insurance is a significant part of investment characteristics, it should be fully disclosed in the prospectus (for instance with the wording or at least a detailed summary). It does not look like multi-page prospectuses for special purpose vehicle (SPV) securities issued in Greensill transactions have this information, neither does it appear in the fund manager reports. Clear disclosure of the insurance structure should allow investors or their advisors to make some form of independent judgment on what is covered. Obligation to make such disclosure should be a condition of a policy.

3. Ability to replace the servicer
Good old practice in securitisations was to have a backup servicer for transactions. In the case of insurance, the asset manager should be co-insured (not loss payee as in Greensill's case), and there should be a market for third-party servicers that can take over the managing of the portfolio including compliance with insurance requirements. Again, in the Greensill case, it appears no such process was in place.

4. Independent policy compliance audits
Regulators such as the UK Prudential Regulatory Authority (PRA) have already picked up that it would be best practice for firms to well-established verify they are 'in compliance with any requirements set out in the insurance agreement.' Creating a market for such an audit is essential for product transparency.

5. Post claims process
Greensill's case showed an important gap in the claims process. With disputes around policies/claims, the insured still has an obligation to minimize the risk. When the investor agrees on restructuring plans with the creditors, it may still be unclear what is the claim status (so the insurer is not coming to the debtor negotiations). There should be a transparent process (such as third-party expert determinations) to ensure such measures cannot be questioned by an insurer when and if the original claim is approved.

6. Other insurances. Insuring other risks?
Credit insurance is only covering risk on non-payment by the buyer on a valid invoice and compliant policy. It is very challenging for any third party to understand the other risks. However, the insurance industry overall has tremendous experience with all different types of risk. Surety providers insure supplier-related risks, D&O insurers cover different wrongdoings by directors and officers, reps, warranties insurance is often done in M&A, etc. There is an insurance product for most things that can go wrong, and there are insurers and teams with deep expertise in these areas.

7. Educating Investors
Unfortunately, many asset managers (and parts of ratings agencies rating funds) have limited experience with insured structures. Therefore, it is essential to inform the investor based on the exact mechanics of credit insurance and risk and mitigants available in such transactions.

A bright future

Despite the Greensill setback, the use of credit insurance products to enhance platform-based transactions has a bright future. Credit insurance may be an extremely valuable mitigant in well designed structures. It is, however, essential to develop quick and efficient safeguards and best practices to ensure this process is not going to lead to high-profile failures and corresponding backlash. ■