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Greensill crisis - some observations for the post-Greensill world

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The ongoing Greensill crisis draws a lot of attention to multiple areas, including supply chain finance, credit insurance, securitisation, use of AI, fund managers, VC investors and others. This article will summarise some of the issues and the underlying reasons.

Supply chain finance

With supply chain finance, several potential questions were asked. These are definitions, impact on the buyer of the goods, supplier of the goods, and the investor/financier.

Definitions

Most practitioners talking about SCF refer to approved payables finance. It provides a fundamental advantage compared to other receivables finance techniques by relying on a buyer confirmation that the invoice is valid, conditions are met, and payment is approved, instead of the seller's claim of the same. As the industry grew, there were attempts to widen the definition, such as by the Global Supply Chain Forum (2016) to include "use of financing and risk mitigation practices and techniques to optimise the management of the working capital and liquidity invested in supply chain processes and transactions." These definitions include a variety of techniques (GSCF also goes on to define each of these techniques separately). Such a broader definition puts very different risk profiles (low-risk "traditional" SCF transactions and more risky and sometimes performance-related structures) into one basket. In the Greensill case, it appears multiple transactions were even outside of these broad definitions, such as the one involving future receivables that look much closer to unsecured cashflow lending. As a result, well-structured and low-risk transactions somehow get associated with these risks. This type of mix-up appears not to be dissimilar to 2008 when ABCP conduits created for perfectly legitimate assets like trade and credit card receivables start investing in all kinds of assets like tranches of subprime CDOs, eventually destroying the ABCP market...

Impact on the buyer

The question of SCF's effect on the buyer of the goods has been puzzling both accounting bodies, rating agencies, and securities regulators for some time, triggered by past cases such as Carillion and Abengoa. The rationale for such concern was mainly the protection of other stakeholders and, to an extent, public shareholders, as such stakeholders did not always receive adequate disclosure of their transactions (leases, project finance, and other types of financing). These concerns were partly addressed by industry best practices and proposed improved disclosure. Greensill's story appears to have very little relevance to these concerns, as the main issue was related to private companies (such as GFG, Katerra, Bluestone, etc.). In these cases, the principal debt losses were taken by either SCF financiers or suppliers who were mainly aware of the transactions, not investors in other debt. Therefore, reclassification or disclosure of these transactions on the books of these private companies would likely be of little help to these stakeholders. The other issue is the impact of the facility's withdrawal. This issue is not specific to SCF, but generally to any uncommitted facility (in the Greensill example, it appears some of the companies have both SCF and non-SCF, bank and nonbank facilities being withdrawn). These events are mainly related to the underlying health of the buyer, not to the type of facility. It is also worth remembering that if the buyer does not know how its receivables are financed, it does not mean the seller does not factor or insure them – it just means the buyer is less aware of potential problems.

Impact on the supplier

While most of the attention in post-Greensill SCF discussions was focused on the buyers, the effect on the suppliers may be significantly more critical. The accounting debate about the treatment of receivables transactions was ongoing for a long time, with both FASB and IFRS addressing it through ASC 860 and IFRS 9 (from a derecognition standpoint). Interestingly, although many Greensill transactions were related to receivables sales, these issues were not even in the frame of accounting discussions while the supposedly less relevant impact on the buyer was. On both sides, reclassification may have formal legal repercussions such as possible covenant breaches, etc.

Related party transactions

The real highlight of the Greensill situation was that many transactions were between somehow related parties. Such transactions put into question the fundamental basis of both SCF and receivables transactions: two independent parties act in their own interests.

Investor/financier risks

"Traditional" SCF – approved payables shifts the risk profile from a mixture of performance risk and credit risk (Is the invoice valid? Has the seller performed? Is the buyer correctly identified? etc.) to essentially the buyer's credit risk. A strong buyer and a well-structured program create a low-risk asset. If the buyer is weaker, the risk can be mitigated with a credit insurance program provided multiple safeguards are in place. However, anything not based on unconditional confirmation of the validity of the receivable and agreeing to pay creates an element of performance risk both in terms of the buyer payment and the insurance policy. In practice, this means that if there is any remaining seller performance risk, the insurance policy is unlikely to mitigate it.

Securitisation

Historical background

Securitisation of trade receivables portfolios started long before the 2008 financial crisis, and well-structured issues showed a high degree of resilience. The critical principle there was a well-diversified pool with significant history and then robust over-collateralisation with significant equity being put ahead of ABCP investors. On top of this, most of the programs have major bank-supported liquidity facilities. Rating agencies used to do a relatively thorough job analysing the pool before looking into any type of external support. This methodology and approach shifted a lot after 2008, focusing on external support and much less on the portfolio. There were also securitisation regulations put in place in multiple jurisdictions post-2008.

Interestingly, **traditional SCF** did not make a significant part of ABCP conduits before 2008 or now. A core reason for this is that it isn't easy to accumulate them into sufficiently diversified portfolios using a buyer-centric approach.

In the Greensill case, some sort of "private securitisation was used, and it appears the risk was not tranched”. This meant as per Sam Woods, Deputy Governor of the Bank of England, quoted by the Treasury Select Committee: "various protections that would apply under that regulation did not apply under the law ... that does seem a bit bizarre". This prompted a call for a review of some of the securitisation regulations. This creates a potentially dangerous 'grey area" between well-diversified portfolios (where a combination of program eligibility criteria, stress-tested over-collateralisation and external support provides sufficient risk mitigation) and single-transaction-based deals where there is apparent transparency on what is sold (i.e., single buyer SCF, or other fully transparent transaction). However, some of the Greensill SPVs appear to be sold through a relatively concentrated mix of non-homogenous transactions without detailed disclosure).

Back up servicing

Another standard feature of securitisation is backup servicing, where an adequately qualified third party can step into the originator's shoes in terms of collections of receivables. If done correctly, this involves full due diligence and setup to ensure such arrangement can be rapidly deployed if needs arise. The absence of such arrangement (that appears to be the case in the Greensill situation) means the investors have to rely on the originator (or their administrator, etc.) to perform such services – and it is unclear why, how well and at what cost they will do so.

Credit insurance

Matching the assets and terms

Core lessons from Greensill are that the existence of an asset pool and a credit insurance policy does not mean the assets are insured. A credit insurance policy typically covers the buyer's risk of paying legally binding invoices for the insured. But first, the supplier needs to be compliant with their contractual obligations, invoice correctly, and comply with the policy terms. The insurance policy may be somehow helpful for future invoices within the policy terms (especially if it has non-cancellable limits). Still, all it does is insure the buyer risk for a valid and compliant invoice when it is done. It does not cover the seller's performance risk, valid contract termination, or continuing supplies when the seller knows about buyers' financial difficulties, etc. Suppliers may find it beneficial for their business (they can check the cover when they grant credit for an invoice). However, financiers can only count on it once invoices are raised, and their contract validity is confirmed.

Loss payee vs. co-insurance

Another critical issue is how investors/financiers can benefit from the policy. Loss payee means that the investor may benefit from the claim payment but cannot control/remedy the policy performance, opening all types of potential issues both before and after the originator's insolvency.

Artificial intelligence and other technology tools

What is it used for?

Here were various statements that Greensill was using some AI in their transactions, then other speculations that they were working out of spreadsheets, etc. So firstly, the question is not if technology is used; it is how and for what purpose. I would suggest that most companies use AI – for example, a mobile phone in their executive's pocket uses AI for image stabilisation in its camera, they may use OCR to digitalise documents, etc. – that does not make it an AI-driven business.

What can be modeled, and how can it be calibrated?

There are two parts of the risks in receivables-based transactions – credit risk and performance risk. In theory, AI can help in predicting such risks. However, for a model to be valid, it needs to be trained on a large through-the-cycle data. That means that there should be a lot of events – credit events in case of credit risk and performance-related events such as delays and dilutions for performance risk. So if the company cannot answer on what data the model is calibrated, this should be the first alarm.

Predicting performance risk does not eliminate it.

It needs to be converted to credit risk. In the case of receivables finance, this is done by combining over-collateralisation and supplier reps and warranties, and this risk is considered separate from the buyer's risk. In 'traditional' supply chain finance structures, supplier performance risk needs to be eliminated. The only practical way for it is that while various technologies (including AI) can be deployed to help the buyer make an invoice approval decision, the buyer needs to take sole responsibility for such a decision.

VC investors

Historically, there was a clear distinction between venture capital and private equity investors. VCs typically were significantly smaller-size transactions, and debt was either not used at all or used from highly specialised technology financiers in the form of venture debt. The PE investors, in contrast, did more significant transactions, used leverage, and had a highly disciplined approach to running such highly leveraged debt. In addition, VCs usually had limited interest in the survival of their investee companies, as their model was based on very high returns produced by a small number of successful exits. The emergence of giant players with essentially VC (as opposed to PE) mentality presented a challenge for banks and debt funds, who viewed them more as PE based on the size (but not the business model). Another unique development was that PE (and even VC companies) historically did not have inter-group financing, except their specialised lending arm. Such changes have created distinct new risks that require careful analyses by funders.

Debt funds

Hunt for yield

Prudent investing was long driven by two principles: "if it is too good to be true, it probably is not," and "do not invest in what you cannot understand." Neglecting them caused most of the financial disasters in human history, and it appears Greensill was just another confirmation of their importance.

Lack of due diligence

It appears the asset invested by the funds was pretty complicated. At the very minimum, it should be reviewed at the level of individual credit exposures, operational process, insurance policies, legal structures, due diligence on originator, etc. This requires both significant internal resources and outside advice. The 'traditional' fund management industry was based on a light-touch approach with culture being shaped by running portfolios of public securities and other more straightforward-to-understand assets. It appears the fund managers did not ask the right questions. Hopefully, the lesson will be learned, and other funds will be more careful with getting the same expertise both internally and externally - in fact I can see positive examples of this happening now in some funds.

Lack of transparency

It appears in some funds, investors have little fundamental understanding of portfolio composition (only high-level summaries), investment process, and risk analyses. Similar to the 2008 crisis, multiple layers of obstruction of underlying data (at the level of structuring, SPV information, and then fund information) existed, making it nearly impossible for investors to understand the underlying risk.

Conclusions

To a great extent, the Greensill case served as a litmus test for policies and controls needed to operate supply chain finance and receivables businesses. It shows that one needs to look behind the product's name (SCF, credit insurance, or securitisation) and gain a thorough understanding of its structure, underlying assets, and risk management procedures. And while there are attractively low risks regarding characteristics of receivables markets, operation there requires expertise and diligence from all parties, including investors. Hopefully, the lessons learned would help to develop a robust market and significantly reduce the likelihood of repeat of such situations going forward.