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CAPITAL

Who’s to Blame for the Greensill Mess?

Since its insolvency just over a month ago, plenty of information has come to light that helps us understand what went wrong at Greensill. Whilst most of the media attention has focussed on the far-fetched activities that Greensill engaged in and proposed (including financing submarines), few have acknowledged that around 60-80% of the loans were of good quality. Had Greensill stuck to this, it would be quietly growing its book with many happy borrowers and investors.

What has stood out to me since I last wrote about Greensill six weeks ago (Credit lessons from the Greensill downfall) is the similarities between the US subprime crisis and Greensill’s problems. Both started out as good operations that pushed risk tolerances too far. Both required a strong supporting cast to work, as both were originate to sell models. Just as rating agencies and investment banks were a necessary part of the subprime disaster, credit insurers and fund managers were needed for Greensill to grow. Here’s my thoughts on the blame attributable to each of the key groups.

Greensill/Softbank

Aggression by entrepreneurs and venture capital investors is celebrated in today’s culture, under a mantra of “grow fast, fail rapidly” or “move fast and break things”. Uber and WeWork are shining examples of this approach, which forgets that most massive businesses like Amazon, Apple and Microsoft took decades of growth to get to their dominant positions. An aggressive approach to growing a lending book can be a particularly dangerous strategy, as a small concentration of bad loans is enough to bring down a financial institution.

By all accounts Lex Greensill loved doing deals. Having Softbank as an investor, itself known for having an extremely aggressive investment strategy, would have added fuel to a raging fire. Given this context of fast growth and creating new ways of doing business, inventing “future receivables” and getting others to fund them is understandable.

What should have happened is that someone at Greensill, like a chief risk officer or chief credit officer, called these out as the long term cashflow loans that they are rather than short term loans secured by actual receivables. These two loan types are very different in their risk profile and investors should have had clear disclosure which was which. It appears that the misnamed cashflow loans are the ones now in trouble, with Credit Suisse flagging $2.3 billion of loans with questionable recoveries out of its $10 billion of Greensill receivables.

Had these loans been flagged as not having meaningful asset backing and requiring long term cashflows to cover their repayment, rational credit insurers and fund managers would have rejected them. This raises the question of whether disclosure was accurate and full, and who undertook due diligence to verify Greensill’s disclosures.

Credit insurers/fund managers

I’ve grouped these two together as over time we’ll find out how the losses are going to be split between these two groups. As Greensill primarily ran an originate to sell model, there’s a natural conflict between their desire to increase volumes and the desire of their funders and insurers to avoid losing money. Greensill’s receivables were offered as insured or uninsured, with funders having the option of receiving a high return if they chose uninsured.

For the insured loans, the obvious question is what due diligence did the insurers undertake? If they did meaningful due diligence, they either look crazy for insuring cashflow loans to weak companies or negligent for not discovering the “future receivables”. It’s possible that there was fraudulent disclosure on the part of Greensill regarding the “future receivables” but a basic level of sampling of invoices would have quickly uncovered this. There may be contractual

exits for the insurers if they were misled. If that's the case, then years of litigation between the funders and insurers are likely as each seeks to push the losses onto the other.

For the funders, particularly Credit Suisse, there's also questions about their due diligence. For those that took uninsured receivables, meaningful investigations on the receivables, the businesses borrowing and the businesses due to pay the receivables would be expected. They have no one to blame if they didn't do their homework. For those that were insured, the fact that they were getting a good pickup in yield over traditional short term investments (bonds, commercial paper, term deposits) meant that a decent level of checks should have been done and there was the additional yield available to pay for that. Between the insurers and funders, someone should have caught the "future receivables" issue and ensured that these didn't proceed beyond a thought bubble stage.

One side note is that at least some of the funders stuck to high quality receivables and they have or will soon see their investments returned in full. This is similar to CDOs during the financial crisis, with plenty of losses on the higher risk securities but full repayments on those with better structures and collateral. From personal experience, it was possible to see the difference between good and bad CDOs in the years before the crash and avoid losses by staying with the lower risk transactions.

BaFin

Germany's financial regulator, BaFin, covers both securities regulation and prudential regulation (banks and insurers). They have had an epic fail in each of these areas in the last year. On the prudential side, Greensill Bank was (i) allowed to run a highly concentrated loan book and (ii) the quality of a fair portion of its loans appears to be awful. The failure of the regulator to monitor for both of these issues is unfathomable given the lessons learnt from the financial crisis. On the securities regulation side, BaFin went after the whistleblowers and journalists that called out the Wirecard fraud instead of taking action to shut it down. Executive recruiters are likely to earn a small fortune in the coming years as competent replacements for BaFin's senior staff are sought.

We might see a level of blowback from other regulators as they look into the capital adequacy of the insurers of Greensill's receivables and the competence and disclosure of the fund managers that took losses on "future receivables". However, this isn't likely to be a substantial regulatory event as in many cases either no losses were taken or those who did take losses are institutional investors with diversified portfolios.

Takeaways for investors

In my previous article on Greensill I covered the credit lessons for investors. Those notes remain valid and I'll add to them with some thoughts on due diligence on fund managers. Most investors and capital allocators look to blue chip fund managers and spend limited time considering emerging managers. The old adage that "nobody gets fired for buying IBM" could easily be replaced with Blackrock, State Street or Vanguard for funds management. Large teams and a long history of steady performance, as well as recommendations from asset consultants, provide comfort to many. In the unlikely event something goes wrong there will be many others in the same situation.

The flip side is that meaningful outperformance is unlikely. This is where emerging strategies and emerging managers have a place. Credit Suisse's Greensill funds seemingly provided a mix of comfort from the brand name and the potential for outperformance from the emerging asset class. The problem was that Credit Suisse appears to have employed second rate people to execute the strategy and the investors in the Credit Suisse funds didn't have the capability to ask the questions necessary to find this out.

In my experience, both of these issues are common. Large brand names often struggle to attract and retain the best people as their organisations have large cost bases that high performers are expected to subsidise. Breaking away to create your own boutique manager has delivered enormous equity outcomes for some, with Magellan, Platinum and a host of hedge funds examples of this.

For capital allocators and investors evaluating fund managers there's a question of whether they are capable to separate the few outperforming managers from the many others that deliver little or negative value after fees. I've found those best placed to ask the right questions are usually people that have experience making direct investment calls themselves. This often shows up in family offices, which combine a mix of direct investments in their areas of specialty with using fund managers to access other asset classes.

Asset consultants and capital allocators with no direct investment experience often struggle to evaluate the technical skills of the fund managers they are considering. The safest option is to select larger managers who are already used by a good number of their peers. This approach typically means they invest with fund managers after their best alpha generation is behind them.

One final aside is that the failure of Greensill and Archegos in the current bullish investment climate is ideal timing. At a time when there seems to be no lack of money chasing unprofitable and dubious investments these are a good reminder that dumb investments eventually lose money. It's good timing as banks and investors are in a decent position to take losses now. That's a silver lining for Credit Suisse, which has been caught up in both Greensill and Archegos, that it is able to reduce its bonus pool as a partial offset to the losses on these bad risks.

Written by Jonathan Rochford for Narrow Road Capital on 17 April 2021. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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