

A Tale of Two Bankruptcies: Why Credit Insurance Needs a Deeper Understanding.

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In 2015, Russell Group published its first white paper on credit insurance. In that white paper, we explained how the credit (re)insurance market helps to provide a measure of corporate stability in an increasingly volatile and connected global trading environment. Simply put, trade credit finance oils the wheels of the global economy as it navigates to an increasingly uncertain destination.



Image: Flickr

The credit (re)insurance market has played an extremely important and positive role in helping to keep global trade ticking along during a fraught and volatile period post 2008. During an age of austerity, astonishing technological advancement, political and cultural division and social unrest, credit insurers have played their part in keeping trade on even keel. The forward looking predictive capability of credit insurance has been invaluable and will continue to provide reassurance to corporates

in what continues to be a challenging time for the global trade environment.

Credit, investment and Political Risk Insurance (PRI) underwriters continue to provide a dual function to their main customers, the suppliers. Firstly, they provide certainty that they will be paid in the event of a default of a buyer and, secondly, they provide an early-warning system when it becomes clear that the buying customer is struggling to meet its obligations.

In normal times, maintaining this balancing act is difficult enough for underwriters, insurers and (re)insurers, but these are not normal times. The worlds of trade credit, investment and political risks insurance are all merging together in the connected world. A world that is riddled with the lurking threats of the Internet of Things (IoT), superpowers emerging in the east and potential local and global conflict areas. Such drivers are connecting potential single points of failure with multiple cross border and financial vertical risk drivers.

Image: Atradius



In other words, welcome to the world of *Connected Risk*.

Over the course of 2017, *Russell Group* has produced extensive research on identifying and analysing the multi-faceted world of connected risk. We have discussed its implications across the multi-class business within the insurance sector and within the wider, global corporate sector too.

This month, we are investigating how the role of credit insurance in protecting exporters is being transformed. It is our contention that credit exposure is one of the central risk drivers in the corporate world today. Despite the terrific work being done by credit insurers to mitigate these short and long-term risks, there is a long way to go before we understand the connecting forces that affect (re)insurers and their corporate clients.

In this paper we examine the current issues and concerns in credit insurance, ranging from the *Toys R Us* bankruptcy to the Mozambique debt

scandal. In addition, we take a panoramic view of the risks facing credit insurance: technology disruption, geopolitical volatility and the global macroeconomic environment.

The Macroeconomic Environment

Starting with the macroeconomic picture, an *Atradius Worldwide* report shows that the global economy has continued to gain momentum over the past months, with a 3.1% expansion projected for this year. Higher inflation, falling unemployment, and strengthening Purchasing Manager Indices (PMIs) all

suggest higher GDP growth in advanced markets. However, the main challenges to the global outlook – the threat of deflation, negative bond yields, austerity, and low commodity prices – are slowly phasing out.

Furthermore, the report highlights that the most high-frequency indicators point to sustained growth: the global composite PMI held steady at 54 in September, pointing to a solid and stable rate of expansion. This has motivated some dramatic upward revisions of trade growth forecasts in 2017.

Oil prices have also been increasing with Brent crude oil reaching about \$58 per barrel. At the same time, U.S. shale production is expected to keep prices muted in the short term, and *OPEC* is likely to extend its production cut agreement past the March 2018 deadline. *Atradius* economist Dana Bodnar concludes that while the outlook for 2018 is optimistic, there remain several downside risks that could very well reverse this. She observes



Image: Guardian

that there is a higher risk that interest rate hikes and quarterly-earning reductions may occur more quickly.

A China “hard landing” is another concern, while U.S. protectionism is another “unknown” for economists. As with other economists, Bodnar is keeping a keen eye on oil price volatility, which she sees as becoming increasingly risky. Finally, there are the geopolitical risks to consider, Bodnar maintains, for example, unrest and violence in the Middle East or North Korea could have a negative impact on global growth.

Technology Disrupts Toys R Us

Against the global backdrop mentioned above, technology disruption played a central role in *Toys R Us* filing for bankruptcy protection this year as the U.S. toy retail chain, which has been wrestling with a heavy debt load, grapples with a shift towards online shopping. According to *The Financial Times*, the company said it secured \$3bn of debtor-

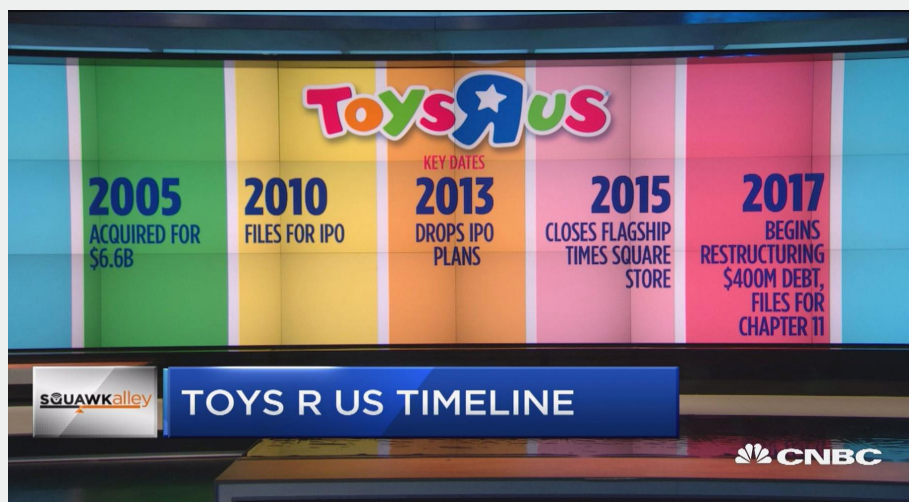


Image: CNBC

in-possession financing to keep its 1,600 stores operating “as usual” during the restructuring of \$5bn of long-term debt. The filing is the latest in a grim year for traditional retailers ravaged by the rising popularity of e-commerce, particularly among companies that took on large debts in the years leading up to the financial crisis.

The bankruptcy of *Toys R Us* also weakened American multinational toy and board game company *Hasbro Inc*’s forecasts for the holiday season in an otherwise strong third-quarter results for *Hasbro*. This, as *Business Insider* points out, bodes ill for a sector worried by the collapse of a major customer.

The *Amazon*-fuelled move away from brick-and-mortar retailing has left *Hasbro* exposed to the tune of \$60 million in unsecured claims for payment. According to *Business Insider*, *Hasbro* was selling about nine per cent of its total inventory through *Toys R Us* stores. “As a result of the *Toys R Us* bankruptcy filing in the U.S. and Canada, there was a negative

impact on our quarterly revenues and operating profit,” *Hasbro*’s Chief Executive Brian Goldner said in a statement.

Debt & Credit Relationship

In the 1987 film, *Wall Street*, Gordon Gekko attempts to buy Bluestar Airlines with the aim of dissolving the company and selling off the assets so he can access the cash in the company’s pension plan. In other words, asset-stripping.

Whilst, Gekko’s plan was ultimately foiled, *Toys R Us* was not so lucky. An analysis, that largely escaped media attention.

After news broke of *Toys R Us* Chapter 11 filing, many retail analysts were not surprised. For, the statistics showed that the writing has been on the wall for *Toys R Us* for a long time. The UK Branch of *Toys R Us* failed to generate a profit for seven out of the last eight years as *The Daily Telegraph* points out. According to *Toys R Us*’ financial records, the consolidated net sales of *Toys R Us* reported in 2016, were \$11,540 million,



Image: Texas Travesty

a decrease of \$262 million, compared with 2015.

Yet, how did the one of the world's largest toy stores get to such a position? The answer is simple: cheap credit.

After being surpassed in US toy sales by *Walmart* in 1998, *Toys R Us* tried to diversify their business model by setting up two new brands: *Kids R Us* and *Babies R Us*. After the failure of *Kids R Us* in 2003, the company announced in 2004, that they were willing to sell their toys stores, and concentrate on the seemingly profitable, *Babies R Us*.

Immediately after the announcement, the company's share prices leaped by fifty per cent, piquing the interest of hedge-fund investors who immediately bought the company.

Remember, this was in the era dubbed the 'Great Moderation', where central bank independence, created ultra-low interest rates, sparking an era of 'cheap credit'. Credit that allowed investors to get access to money instantly and allowed them to take out huge loans to purchase companies.

Loans, which would then be saddled onto the purchased company. A perfect example of this is the controversial Glazer family takeover of Manchester United from 2003 to 2005. A takeover that was achieved through £800 million in loans



against the capital assets of the club, resulting in Manchester United paying interest payments of over £60 million per annum.

So, it was no surprise when in 2005, *Toys R Us* was purchased by *Bain Capital, K.K.R & Co. LLP*, and *Vornado Realty Trust*, for a combined figure of \$6.6 billion dollars.

After purchasing *Toys R Us*, according to *The New Yorker*, the investors reorganised the corporate structure of *Toys R Us*, splitting off the real-estate (a flagship store in Times Square, New York) to entice more investors, which added to the company's growing debt levels.

The question credit insurers should be asking is not *why* did *Toys R Us* go bankrupt but rather *how* did it stay afloat for so long? It survived the 2008 global financial crisis, watching on the sidelines as the sub-prime mortgage industry exploded, and customers lost their homes.

Even in 2010, the investors were still not finished, as they

attempted to put the company on an initial public offering to cash out their investment. This attempt failed but the investors were still cashing in \$470 million in fees and interest payments from *Toys R Us*. Consequently, it was no surprise that at the time of its filing for Chapter 11 bankruptcy, *Toys R Us* debt level was \$5 billion, with \$400 million in debt service payments, surpassing the amount the company spent on all its stores and computer systems, and ultimately led to the end for the company

A Deeper Understanding of Connected Risk is Needed

According to *Bloomberg*, the rate for credit-default swaps for *Toys R Us* on the day after U.S. Labour Holiday (3rd September 2017) were priced at a low probability of a near-term default (10%). At that time, \$10 million of *Toys R Us* debt could be insured for an upfront payment of \$300,000. Yet, on the eve of bankruptcy filing, that upfront cost had surged to \$7.7 million, due to a news leak, causing the market to react.

In simple terms, credit insurers did not see this coming. An issue which goes to right to the heart of the connected risk challenge. How can credit-default swaps for *Toys R Us* be priced with a low probability of default, given that *Toys R Us* was saddled with sky-high debt, declining sales and market share being eroded by online retail?

Based on the case study of *Toys R Us*, it seems that credit insurers did not fully understand the scale and scope of the challenge of connected risk, in the form of online retail and the lack of investment in this area.

Looking at the wider picture, it is true that credit insurance companies look not just into individual buyers, but also industry sectors and at a national level to forecast developments. They use many sources to do that, and have many clever economists, actuaries and industry experts to form expert opinion, but is this enough?

The interconnected world exposes companies to more than financial risk. Digital disruption and social media are changing corporate business models, and are forcing tighter integration between departments, removing siloed thinking and promoting faster corporate decision making as information flows quicker to decision makers. Furthermore, online and



Image: Mojix

offline business models need to be better integrated, so that the customer experience is seamless.

The effect of this digital disruption does not just affect the organisation it also effects the supply chain, because an organisation doesn't operate in a silo, it operates in a network composed of its supplier, partners and clients. Disruption can be positive when all constituents of the network are aligned in the same way, but it can be negative when the constituents of the network are not aligned. The latter was a contributing factor in the demise of *Toys R Us*, and which the credit insurance sector needs to learn from.

In our view, companies need to be measured to quantify their exposure to connected risk, and this connected risk score should be used to assess the potential failure of a company alongside tradition balance sheet risk.

Mozambique's Millions

Meanwhile, state companies at the heart of Mozambique's debt scandal failed to account for at least a quarter of more than \$2bn in contentious loans, according to an auditor's report that was reported by *The Financial Times*.

The loans were taken out in 2013 when the southern African nation said it wanted to set up a state-backed tuna fishing company. But they were hidden from the *International Monetary Fund* (IMF) and donors, and their discovery plunged what had been one of Africa's star economic performers into a financial crisis.

Donors, which provided about a quarter of the government's budget, suspended aid and the government defaulted on the state-backed loans just as it was hoping to develop vast offshore gas fields and attract greater foreign investment.



The Guardian reported that Mozambique could be the first in a wave of states facing a new debt crisis sparked by the commodity price crash. Like many poor countries, Mozambique is vulnerable to falling commodity prices and higher interest rates.

Collapse in Commodity Prices

The collapse in global commodity prices and a stronger United States dollar have depleted the public coffers of some of the world's poorest countries and will leave them as much as \$61bn (£43bn) worse off this year, a report by *Jubilee Debt Campaign* has warned.

The report stated that countries reliant on exports of commodities such as metals and oil had seen government revenues hit by a global markets rout last year

that knocked the prices of crude oil, iron ore, copper and other raw materials to multi-year lows.

At the same time, a drop in their currencies against the US dollar are making it harder for governments in developing countries to make debt payments in dollars. So, is this indicative of a wider trend related to the low interest rate environment globally fuelling cheap money leading to over leveraging in debt terms?

Credit insurers, certainly those writing political risk and credit risk to public buyers, are very aware of debt situations in the companies they are underwriting. They also look carefully at the debt obligations of Governments and, but credit insurers were caught out by Mozambique – they did not see it coming.

Not all Doom and Gloom

Even with Mozambique it is not all doom and gloom because it is clear to see that credit insurers continue to write new business in that country. A lot of this new business is project finance in the commodities sectors – oil, gas and aluminium – and indeed that is the bulk share of the business currently written in Mozambique.

According to analysts, the real cause of problems for Mozambique and other countries is the drop-in commodity prices. This had led to some countries that depend on commodity exports ending up in trouble. Angola is another case, whilst Nigeria and Russia are dependent on oil exports.

Old Credit Insurance Certainties Breaking Down

As this report demonstrates, however, it is impossible to take a broad-brush view of the global trade credit risk environment because the old certainties are breaking down. Globalisation connects a multitude of risks yet in the longer term there is increasing distrust between different governments, and between governments, corporates and electorates, leading to demands to retract from regional and global integration.



Image: gartner.com

Whilst, these structural changes are sweeping through the wider economy, credit insurers are still clinging to their traditional siloed thinking. A view that is amplified by our choice of the two case studies of Mozambique and *Toys R Us*. Both, were locked in a cycle of borrowing debt, adding debt and servicing that debt. A cycle that was fuelled by the era of cheap credit.

Yet, despite this, credit insurers ignored the warning signs as their models failed to incorporate these triggers. Thus, premiums were cashed, and few questions were asked, as credit was only insured for a maximum of a year, so there was no need for a thorough analysis.

Consequently, when *Toys R*

Us filed for Bankruptcy and Mozambique revealed its debt levels, credit insurers were caught out. So, what can credit (re)insurers do to help themselves and in turn help corporate risk managers?

Well, firstly, they need to change their short-term approach of only focusing on looking a year ahead, and understand the long-term picture. In today's connected world, which is changing in an instant, such an approach is flawed.

This brings us to the second and last point, which is credit insurers need to adopt a new framework in assessing how they insure credit in the first place. For to truly execute business strategy in a connected world, one

must understand that an organisation's markets, clients, suppliers and partners all operate in interconnected networks. Such a framework, allows credit (re)insurers and in turn corporate risk managers and underwriters to effectively understand the landscape they really operate in.

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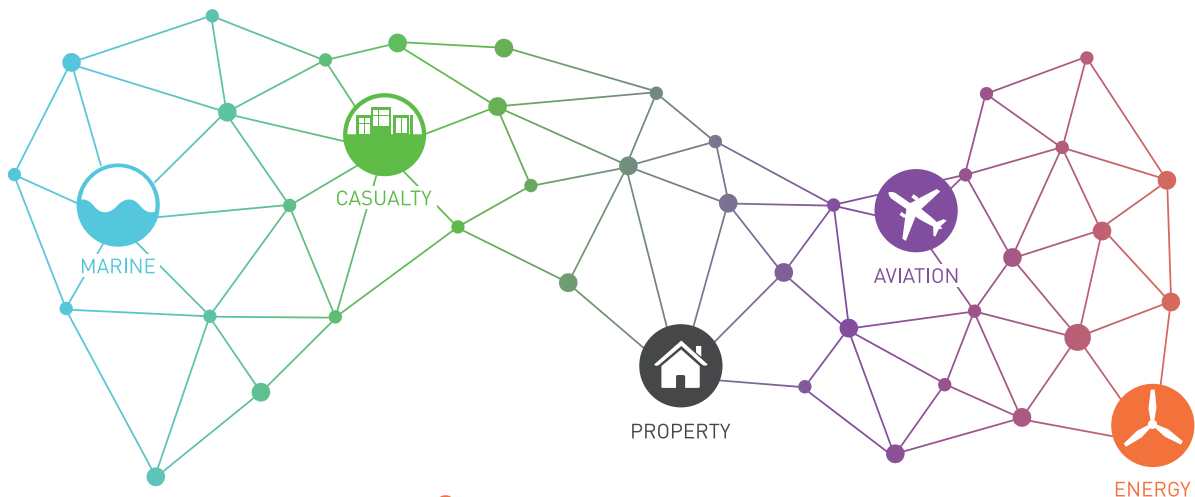
Russell Group is a leading risk management software and service company that provides a truly integrated risk management platform for corporate risk managers and (re)insurance clients operating in an increasingly connected world.

Connected risk refers to the growth in companies which are increasingly integrating across industrial sectors and geographies, and creating greater levels of risk. This exposes corporates and (re)insurers to a broader range of inter-related perils, which requires a risk management approach built upon deep business intelligence and analytics.

Russell through its trusted ALPS solution enables clients whether they are risk managers or underwriters to quantify exposure, manage risk and deliver superior return on equity.

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Managing Risk in a Connected World



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