

# A Strong Recovery Requires a Healthy Trade Credit Insurance Industry

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July 9, 2020

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# A Strong Recovery Requires a Healthy Trade Credit Insurance Industry

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## Summary

Trade credit insurance (TCI) – which covers the risk that firms may not be paid by their buyers – is of critical importance to the U.S. economy. TCI provides a financial backstop to firms employing over 2 million American workers, and conservatively protects \$600B in annual U.S. sales. Without this safety net, these firms, 60 percent of which have revenues of \$20 million or less, would be unable to sustain their current production levels, let alone expand their sales, which would disrupt supply chains and cause significant damage to our economy.

This safety net is now at risk. We find in this study that because of the sharp increase in economic uncertainty due to the COVID-19-induced recession, U.S.-based trade credit insurers already have cut back their coverage by almost 14 percent since year-end 2019. TCI insurers could make additional coverage cuts due to increased uncertainty stemming from the recent spiking of COVID infection rates throughout much of the country and if the widely predicted “second wave” of the pandemic arrives this fall or winter.

With less TCI coverage, insured companies will be less able to meet rising demands for their goods and services as consumer demand generally picks up and also will have reduced credit lines from banks that rely on companies having TCI policies, thereby reducing the strength of the recovery from the recession.

We estimate that the cutback in TCI coverage so far, in the absence of countervailing policy intervention, will inhibit gross supplier output conservatively by \$46 billion and the hiring of approximately 155,000 workers by supplier firms. Inhibited output and job creation by downstream buyers would add to these estimated impacts, as would future additional cutbacks in TCI insurance coverage.

The adverse impacts of TCI coverage cutbacks can be avoided, however, if the U.S. government were, for a temporary period, to share in some manner with the TCI industry the non-payment risk of TCI customers. We discuss a temporary government reinsurance program proposed by three private insurers for doing this, funded in part by market-determined reinsurance premiums paid to the federal

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Funding for this paper was provided by Atradius, Coface, and Euler Hermes. The views of the authors are their own.

government. Such a program draws on best practices from similar approaches that have already been adopted or are being considered in other G-7 countries.

## I. Introduction

The pandemic-triggered downturn has exposed a variety of weaknesses in the U.S. economy that need shoring up if the immediate economic damage from state lockdown orders is to be minimized and the strength of the recovery as those orders are gradually relaxed is to be maximized.

Up to this point, the Congress and the Federal Reserve have undertaken unprecedented actions to limit the overall damage to the economy from the pandemic – through payroll protection especially for small and medium size businesses, unemployment insurance, and Treasury and Fed loan programs.

But much more will be needed to sustain as vigorous a recovery as possible. Congress is recognizing that need by considering supportive measures to extend unemployment insurance and expand current assistance programs.

One corner of the US economy that will need help, which to date has not been widely appreciated, is the trade credit insurance (TCI) industry and their policyholders. In the United States, approximately 14,000 suppliers of goods and services rely on TCI carriers to cover the risk of non-payment by buyers or customers of these suppliers. In the aggregate, TCI policies conservatively supported \$600 billion in business-to-business sales by suppliers in the U.S. at year-end 2019.<sup>2</sup>

Although businesses of all sizes benefit from credit insurance, it is especially critical to small and medium-sized enterprises (SME) – those suppliers of goods and services with annual revenues of \$20 million or less -- which comprise approximately 60 percent of all TCI policyholders. These SME policyholders are an important backbone of the U.S. economy, not only as important employers and powering job growth, but also include virtually all young companies that traditionally have driven

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<sup>2</sup> The TCI insurers collectively provided in the U.S. an estimated \$400 billion in coverage for non-payment to policyholders at year-end 2019. Because sales turn over multiple times a year, the coverage figure protects a larger amount of sales. For purposes of this study, we use a conservative estimated 1.5 ratio of sales-to-coverage to arrive at the \$600 billion in annual covered sales estimate reported in the text.

innovation, the key to long run growth in GDP and hence the growth of average U.S. living standards.<sup>3</sup> Furthermore, because TCI policyholders, small and large, tend to be suppliers to manufacturers and retailers, TCI is essential to the smooth operation of industry supply chains, and thus of the overall economy.

Yet because of the COVID-19 crisis, and the resulting financial fallout suffered by many customers or buyers of goods and services sold by TCI policyholders, trade credit insurers expect to suffer substantially higher-than-expected claims on their policies and justifiably fear further elevated losses in a new risk environment. As a result, TCI carriers have had no choice but to cut their exposure to their policyholders by reducing or cancelling credit limits on their buyers. This outcome is driven by the huge remaining uncertainties about the course of the pandemic, the policy and economic responses to it, and the insurers' need to maintain capital cushions to support the coverage they provide going forward. TCI policyholders now have less TCI coverage, which cannot be supplemented by new entrants in any reasonable time frame. Because of this, they are less able to ramp up production of supplies to retailers and manufacturers as they seek to respond to rebounding consumer demand as state-ordered lockdowns are gradually relaxed and more people are willing to venture out of their homes, for work, to shop and to engage in recreational activities.

As we demonstrate in this study, the cutbacks in TCI coverage threaten to inhibit sales by affected policyholders by an estimated \$46 billion in gross output, and thus prevent the creation of approximately 155,000 jobs at supplier firms. These are conservative estimates for multiple reasons detailed in the report. One way that the federal government could diminish these threats to the strength of the recovery would be to provide reinsurance, on a time limited basis, to the TCI industry, analogous to similar programs enacted or considered in other G-7 countries. Such a program would reverse much of the cutbacks in TCI

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<sup>3</sup> See, e.g. William Baumol, Robert E. Litan and Carl Schramm, *Good Capitalism, Bad Capitalism* (New Haven: Yale University Press, 2007).

coverage, and the economic effects associated with them. U.S. government action also would level the playing field for policyholders and their customers relative to other countries that have protected or are considering backstop programs for TCI insurers. Indeed, in a recent letter to the Administration, 22 trade associations representing most of the manufacturing, distribution and retailing sectors of the U.S. economy – which have been hardest hit by the risk-induced cutbacks in TCI coverage and that collectively are key to meeting rebounding customer demand – specifically asked the Administration to establish a government-backed reinsurance program on an emergency and temporary basis.

This paper explains how trade credit insurance works; why it is critical to the health of suppliers of all sizes, but especially to small and medium-sized businesses, and hence to the overall U.S. economy; why the pandemic-triggered downturn has required trade credit insurers to limit their coverage; the impact of reduced coverage on policyholders going forward; and concludes with a discussion of a reinsurance proposal for addressing the problem.

## **II. What is Trade Credit Insurance?**

Trade credit insurance is a type of insurance product that protects policyholder suppliers, principally small to medium sized companies, against the risk of non-payment by their buyers, such as manufacturers, distributors, and retailers. The insurance indemnifies the policyholder up to a specified credit limit, by buyer and in the aggregate, if buyers are delinquent for at least a specified period or become insolvent. In the process, trade credit insurers take credit risk off their policyholders' balance sheets, reducing any bad debt reserves, and thereby bolstering their profitability.

TCI does more than that for its policyholders, however. The insurance coverage is often used by insured suppliers to obtain credit from banks, providing policyholders with the liquidity they need to buy inputs and pay workers while waiting to be paid by their customers or buyers. More broadly, having TCI

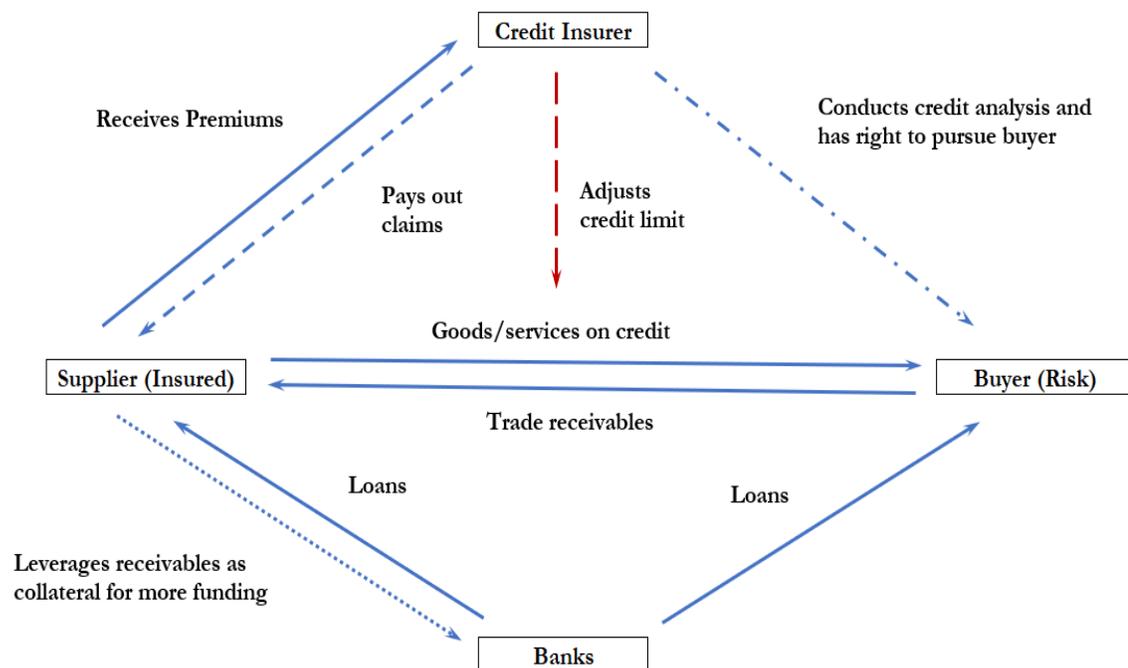
coverage can be the deciding factor in whether suppliers have sufficient comfort to take on any additional production orders at all, facilitating the smooth operation of entire supply chains.

Because readers may be unfamiliar with the TCI industry, certain terms can be confusing. To minimize that risk, throughout this report, we refer to the purchasers of TCI coverage as “policyholders” or “insured suppliers” and those who purchase goods and services from policyholders, such as manufacturers, distributors or retailers, as “buyers” or “customers.”

TCI insurers manage the credit risk they take on by continuously evaluating the commercial risk of non-payment by buyers of goods and services from TCI-covered suppliers. Some of this risk is buyer-specific, but part of it also is industry-wide and can be affected by political decisions.

Exhibit 1 below illustrates how TCI works and why it is central to the smooth operation of supply chains. The exhibit shows how TCI plays a critical role in the middle of the supply chain, both in mitigating risk for policyholder firms and in serving as collateral for bank financing for them.

### Exhibit 1. Cashflow and Risk Transfer Diagram for TCI Participants



At year-end 2019, \$600 billion in business-to-business U.S. sales, conservatively estimated, were covered by trade credit insurers.<sup>4</sup> Although a small portion of U.S. credit insurance exposure is written for export deals, 81 percent of exposure facilitates trade between U.S. companies,<sup>5</sup> underscoring the importance of insurance coverage in the domestic supply chain and economic landscape.

Unlike other insurance products, which extend fixed amounts of coverage to insureds over a fixed period of time (typically one year), credit insurers can adjust their credit limits -- maximum covered amounts of trade receivables due from buyers of goods and services sold to them by policyholders -- upwards or downwards during the policy period. This type of dynamic evaluation and adjustment of credit limits is made possible by the insurers' continuous monitoring of credit risks throughout the economy, which is especially important at times when the credit cycle is turning or when economic uncertainty is rising. TCI insurers' ability to vary credit limits under their policies also enables them to charge lower premiums than if they were committed to fixed credit ceilings throughout an entire policy period, during which economic conditions can drastically change.

The COVID-19 pandemic shock has starkly illustrated what can happen to TCI markets when payout risks soar or become highly uncertain. With the onset of the crisis, trade credit insurers have scaled back their coverage significantly or have stopped covering sales to (or receivables from) high-risk sectors altogether. Insurers have also become much more hesitant about taking on new business.

Although these are rational and normal responses by the insurers, legitimately worried about the extent to which future claims payments will erode their ability to maintain their buyer credit limits, they

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<sup>4</sup> See footnote 2 for an explanation of this estimate, which we believe to be conservative.

<sup>5</sup> James Daly, CEO, Euler Hermes North America, The Case for a Partnership between Trade Credit Insurers and the U.S. Government. Available at <https://www.cfo.com/risk-management/2020/05/the-case-for-a-partnership-between-trade-credit-insurers-and-the-u-s-government/>.

come at a time when the U.S. economy also has sharply contracted. Now that the economy is beginning to rebound, the strength of the recovery will depend on how quickly manufacturers and retailers can respond to increased demand for their products, and as a result additional TCI coverage provided to their suppliers will be even more critical than usual.

One natural question to ask is whether, instead of curtailing coverage limits, trade credit insurers could maintain them while charging higher premiums in the future -- after current annual contracts expire -- to compensate for pandemic-driven increases in risk. Higher premiums for this purpose are not the answer, however, for several reasons.

Many policyholder firms, especially smaller and medium sized ones, are struggling in the current extraordinary economic environment to meet their other fixed commitments, such as interest payments on debt and (in some cases) rent, as well as doing their best, even with the payroll protection program in place, to pay workers they do not want to lose. Many, if not most, policyholders facing a cash squeeze understandably are likely to prefer a reduction in their coverage limits – to be more in line with their reduced output and sales revenue – than paying for higher coverage limits they are not sure they will need.

Moreover, even if insurers could collect higher premiums in the future once current policies renew, they must deal with the immediate uncertainties in the meantime surrounding future claims amounts under existing policies that depend on factors outside their control: the future course of a highly unpredictable virus – which is now rapidly spreading throughout much of the country -- and the political and economic responses to it. Added to this is the fact that pandemic-related economic risks are highly correlated, which makes them difficult to insure against, as discussed further in Section IV below.

The risk-minimizing strategy for insurers in this highly uncertain environment, therefore, is to rely on cutting coverage limits. Suppliers and economic policy makers cannot count on new entry into the TCI business to offset the reductions in coverage by existing insurers, given the substantial credit data that new entrants would need to compete prudently, as well as the time required to receive necessary regulatory

approvals from all states. In later sections of this paper, we describe and estimate the impact that the coverage reductions made so far have had or are likely to have, absent a policy response addressing this challenge.

### **III. Why is Trade Credit Insurance Vital to the U.S. Economy?**

In a market-oriented competitive environment, suppliers need to make credit available to purchasers, but that often comes at a cost when the extended credit becomes too risky to manage. Every dollar in accounts receivable is one less dollar that the supplier has in cash. Just one buyer's default with a sufficiently large accounts receivable balance could drive a supplier out of business. Hence, many suppliers want to purchase TCI to ward off or minimize the financial risks of not collecting amounts due them from their buyers.

With \$600 billion in U.S. trade conservatively covered by TCI policies, TCI insurers benefit U.S. businesses of all sizes by absorbing much of the risks in business-to-business sales. This risk-absorbing function, in turn, supports the entire supply chain, from raw materials to suppliers, manufacturers, distributors, retailers, and ultimately customers. An estimated 80 to 90 percent of global trade is supported by some type of trade credit insurance.<sup>6</sup> TCI thus is a silent engine that helps keep supply chains, in the U.S. and around the world, operating smoothly, facilitating the delivery of goods and services that consumers demand.

TCI coverage is especially important for small to medium sized companies. One common definition of SMEs defines them as firms with 500 employees or less. As trade credit insurers do not have

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<sup>6</sup> World Trade Organization (WTO) estimate, available at [https://www.wto.org/english/thewto\\_e/coherence/challenges\\_e.htm#:~:text=Some%2080%25%20to%2090%25%20of%20world%20trade%20relies%20on%20trade,of%20a%20short%20term%20nature.&text=Particular%20emphases%20was%20placed%20on,ways%20of%20financing%20trade%20operations.](https://www.wto.org/english/thewto_e/coherence/challenges_e.htm#:~:text=Some%2080%25%20to%2090%25%20of%20world%20trade%20relies%20on%20trade,of%20a%20short%20term%20nature.&text=Particular%20emphases%20was%20placed%20on,ways%20of%20financing%20trade%20operations.)

data on employee counts on their insureds, since the object of the insurance is to cover accounts receivable, the definition of SMEs we use here is a conservative one, consisting of firms with annual revenues of \$20 million or less. These SME policyholders account for 60 percent of TCI coverage sold TCI carriers,<sup>7</sup> are important employers, and include startup companies, which drive innovation and living standards growth. TCI provides risk mitigation and liquidity for these SME policyholders, not only by protecting them against the risk of non-payment by buyers but also by serving as collateral for bank loans or lines of credit, that these companies need to meet rising demand from their customers, expand into market segments or to compete with larger, more financially secure firms.

Exhibit 2 summarizes the key benefits of trade credit insurance to various players of the U.S. economy.

## **Exhibit 2. List of Key Benefits to Trade Credit Insurance Participants**

<b>TCI Participants</b>	<b>Key TCI Benefits</b>
<b>Insured Policyholders</b>	<ul style="list-style-type: none"> <li>• Mitigate non-payment risk of bad debt from balance sheet</li> <li>• Improve profit margins and boost P&amp;Ls</li> <li>• Increase sales growth and expand markets</li> <li>• Reduce bad debt reserves and enhance working capital</li> <li>• Obtain more attractive bank funding</li> <li>• Access to credit management services</li> <li>• Cost-effective alternative to bank guarantees and letter of credit</li> </ul>
<b>Funding Banks</b>	<ul style="list-style-type: none"> <li>• Lower credit risk for loans</li> <li>• Increase lending with insured receivables as collateral</li> </ul>
<b>The US Economy</b>	<ul style="list-style-type: none"> <li>• Lower systemic risk of supply chain disruptions</li> <li>• Facilitate business-to-business transactions</li> <li>• Increase employment, especially for SMEs</li> <li>• Support broad-based economic growth across industries</li> </ul>

To highlight the benefits of TCI to policyholders, and by extension to the overall economy, consider two numerical examples of a hypothetical supplier whose accounts receivables are backed by a TCI policy.

<sup>7</sup> Estimate calculated from data provided by three insurers funding this paper.

Exhibit 3A shows that for an insured supplier currently with \$1 million in sales but with another \$1 million in orders, TCI coverage to permit that growth would generate *safely* another \$146,250 to the firm's bottom line, without the supplier having to worry about non-payment.<sup>8</sup>

Exhibit 3B shows another advantage of trade credit insurance and how it could enable the hypothetical supplier with \$1 million in receivables to obtain an additional \$100,000 in bank funding.

Together the two exhibits demonstrate how trade credit insurance provides policyholders with additional cashflow and working capital, which can then be invested to increase production, hire more workers, or expand into new markets.

Exhibits 3A and 3B also demonstrate that without additional TCI coverage, suppliers are not able to offer more goods or services to their buyers, without considerably greater risk, when the policyholders' credit limits reach their ceilings. In addition, uncovered suppliers cannot leverage their accounts receivables with banks for more funding, which further limits their capacity to grow their businesses.

### **Exhibit 3A. Example for Net Profit Gains for Insured Supplier**

<b>Current Credit Limit for Supplier's Customers</b>	\$1,000,000
<b>Desired Credit Limit</b>	\$2,000,000
<b>Potential Increase in Accounts Receivables</b>	\$1,000,000
<b>Annual Sales Turnover</b>	1.5
<b>Potential increase in Sales with TCI Insurance</b>	\$1,500,000
<b>Gross Margin</b>	10%
<b>Potential Gross Profit Gains from TCI</b>	\$150,000
<b>TCI Cost (% of Accounts Receivables)</b>	0.25%
<b>Potential Net Profit Gains from TCI</b>	<u>\$146,250</u>

<sup>8</sup> This calculation is based on a conservative assumption of annual sales turnover of 1.5. For a higher turnover of 3.0, the potential net profit gain is \$292,500.

### Exhibit 3B. Example for More Bank Funding for Insured Supplier

Domestic Accounts Receivables (A/R)	\$1,000,000
Current A/R Advance Rate, without TCI	80%
Current Funding Capacity, without TCI	\$800,000
Potential A/R Advance Rate, with TCI	90%
Potential Funding Capacity, with TCI	\$900,000
Total Increased Funding and Working Capital	<u>\$100,000</u>

Another way to illustrate the economic importance of TCI is to consider the buyer sectors that benefit from TCI coverage of their suppliers, as shown in Exhibit 4 below. The exhibit highlights the reach of TCI protection across much of the U.S. economy.

### Exhibit 4. Major Sectors Benefitting from TCI Coverage

Sector
• Agriculture & food industry
• Business services (except financial)
• Chemicals
• Clothing
• Construction and real estate
• Construction materials
• Consumer electronics
• Manufacture of fabricated metal products
• Mechanical engineering
• Metals
• Motors vehicles and motorcycles
• Non specialized trade
• Paper products
• Pharmaceutical and Cosmetics Industries
• Utilities and public services

In sum, TCI not only helps lubricate supply chains, but also facilitates expansion by insured suppliers and their buyers, and thus is of critical importance to the U.S. economy.

#### **IV. Damage to the TCI Industry from the COVID-Induced Recession**

The COVID-19 pandemic has triggered the deepest, most rapid economic downturn in this nation's history.<sup>9</sup> A number of analysts have likened the state lockdowns implemented to “flatten the curve” of new infections to keep hospitals from being overrun with COVID-19 patients as having put the U.S. economy into a medically-induced coma, from which until recently it was gradually awakening – but which may now or soon be interrupted due to rising COVID infection rates throughout much of the country.

The TCI industry has been hit hard by these events in two respects. First, the recession has already led to a sharp rise in current and expected bankruptcies or severe economic dislocations throughout the economy – but especially the retail sector and throughout small and medium sized businesses. *These dislocations are precisely the kind of events that trigger claims on TCI policies.* All of this has happened despite the extraordinary scale of the multiple government rescue plans – payroll protection, lending through the Treasury and the Fed – implemented rapidly in a highly polarized political environment.

As bad as the immediate recession-induced effects have been and are likely to be, a potentially worse risk for the TCI industry going forward is the elevated uncertainty about future events that will inevitably affect the ability of insurers to extend even already lowered credit limits on the customers of their policyholders, absent some outside policy intervention. There remain huge unknowns about the course of the virus – the recent rapid growth of infections and hospitalizations in many states being an especially serious cause of concern – and the reactions by consumers, workers, and state and federal policymakers to virus trends going forward. Especially worrisome are consensus warnings of infectious disease specialists that in addition to the “first wave” that shows no signs of ending any time soon, an

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<sup>9</sup> The National Bureau of Economic Research (NBER), the official committee for the declaration of business cycles, has announced that February 2020 marks the beginning of a US recession and the end of the longest expansion of the US economy since June 2009. Available at <https://www.nber.org/cycles.html>.

even more serious “second wave” of the virus is likely this fall, coinciding with the onset of the regular flu season. Clearly, any worsening of the virus will produce not only more human tragedy, but also could easily interrupt and reverse the current recovery. Indeed, even once an effective vaccine is approved and widely deployed, the economy will be weakened for years. The nonpartisan Congressional Budget Office has estimated that it will take *a decade* for a full recovery from the 2020 deep recession.<sup>10</sup>

All this is to say that TCI insurers, like everyone else in the economy, are facing extraordinary risks to their businesses, because the customers of their policyholders are facing those same risks. Indeed, the fact that so many businesses and regions of the country will continue to face virus-related risks runs up against the economics of providing insurance, which can only be provided if risks are reasonably independent of one another – so that high claims in some geographic areas or in some industries may be offset by low claims in other areas and sectors. The pandemic-associated economic risks are not like that: the pandemic has damaged large swaths of the economy – grocery stores, online retailers, and delivery services being notable exceptions – and it is marching across the American geographic landscape like a stealth army with inconsistent, and in too many places little, resistance.

As a result, TCI insurers now face highly correlated uninsurable events that will trigger unusually high claims. Insurers have only one weapon to deploy against these highly correlated risks, namely, to cut insurance coverage limits substantially across the board, which is precisely how the insurance is supposed to work in elevated risk environments. As long as the unprecedented uncertainties about the future course of the virus and the economy continue, TCI insurers will have little or no incentive to raise any of their current insurance ceilings or to aggressively seek out new policyholders posing new, often untested risks. To the contrary, any increase in economic risk may induce TCI carriers to lower insurance ceilings even further.

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<sup>10</sup> CBO projections, June 1, 2020, available at <https://www.cbo.gov/system/files/2020-06/56376-GDP.pdf>.

## V. Threat to the Strength of the Recovery from Cutbacks in Trade Credit Ceilings

TCI insurers already have cut back their coverage ceilings from year end 2019 levels by an average of 13.8 percent as of the end of May 2020.<sup>11</sup> Although all sectors of the economy have been adversely affected, the industries shown in Exhibit 5 have been especially hard hit by coverage cutbacks by one or more of the insurers.

### Exhibit 5. Sectors with Above Average Cutbacks in TCI Ceilings

Sector
• Automotive
• Construction
• Consumer Durables
• Electronics
• Metals
• Retail (including Brick and Mortar)
• Services (including Hospitality & Restaurants)
• Textiles (including Apparel Manufacturers)
• Transportation (including Airlines)

To translate an aggregate estimate of the impact of the 13.8 percent coverage cutback into economic effects, we project that the reductions will have a proportionately greater impact on smaller, cash constrained supplier policyholders than on larger ones. Specifically, we conservatively assume that for smaller policyholders, every dollar of coverage reduction translates into 75 cents of inhibited production, whereas the similar number for larger insureds is 25 cents. On these assumptions, Exhibit 6 illustrates that starting from \$600 billion in covered US gross sales, a 13.8 percent reduction in TCI

<sup>11</sup> The industry-wide cutback is calculated as the weighted average of the cutbacks by the three insurer sponsors of this paper, individually and confidentially supplied to the authors (with the weights based on the market share of each insurer).

coverage would likely inhibit \$46 billion in US gross sales by suppliers (not counting downstream impacts on manufacturers and retailers) as the economy picks up steam.

### Exhibit 6. Estimated Inhibited Sales by Suppliers Due to TCI Coverage Reduction

	<u>US TCI Industry</u>	
2019 TCI-Covered US Gross Sales (\$ Billions)	\$600	
2020 US TCI Industry Coverage Reduction Ratio	13.8%	
Estimated Reduction in US TCI Coverage	\$83	
	<u>Small and Medium</u>	<u>Large</u>
	<u>Enterprises</u>	<u>Enterprises</u>
Breakdown between Customer Type	60%	40%
TCI Coverage Reduction (\$ Billions)	\$50	\$33
Sales Reduction Per Dollar of Coverage Reduction	75%	25%
Estimated Inhibited US Gross Sales by Suppliers (\$ Billions)	<u>\$46</u>	\$37      \$8

This \$46 billion figure,<sup>12</sup> however, represents an *under-estimate* of the output inhibiting impacts of the coverage cutbacks traced to the pandemic for multiple reasons. One reason is that the coverage limit calculation does not take account of the foregone increase in bank credit, and thus liquidity, that lower coverage limits mean for policyholders. Second, for reasons already highlighted, continuing economic uncertainties surrounding the impacts of the recent spikes in infection rates throughout much of the country – which could be greatly aggravated by a serious second wave of the virus in the fall – could easily trigger additional cutbacks in insurance coverage, on top of those already imposed. Third, given the elevated economic uncertainties, TCI insurers may not be able or willing to aggressively seek out new business from suppliers that are not currently insured, but who clearly would benefit from it, or would if they had it before the pandemic broke out. One recent media story illustrates how food sellers strapped for cash due to non-payment from buyers, and presumably without TCI coverage now, are worried about

<sup>12</sup> The \$46 billion total is larger than the apparent sum of \$37 billion and \$8 billion for SMEs and large firms, respectively, in the table, because of rounding of the last two figures.

being able to accept new orders from buyers who have not yet made good on the sellers' existing accounts receivables.<sup>13</sup>

Even a \$46 billion adverse impact on U.S. gross supplier sales could inhibit the hiring of a sizeable number of U.S. workers. By our calculations, illustrated in Exhibit 7, suppliers would be inhibited from creating approximately 155,000 jobs, roughly 60 percent of them concentrated in small to medium sized businesses (the share of such businesses in TCI insurers' customer base). The job inhibiting impact would be worse to the extent that the \$46 billion gross output estimate understates, for the reasons just given, the output inhibiting impact from the ultimate pandemic-induced coverage cutbacks.

Finally, and perhaps most important, both the output and jobs estimates presented here are limited to impacts to suppliers and do not account for the additional inhibited value added downstream at the manufacturer and retail levels. Accordingly, both the output and job estimates presented here are conservative lower bound estimates of the total inhibited output and job creation impacts for the entire economy due to TCI insurance coverage cutbacks.

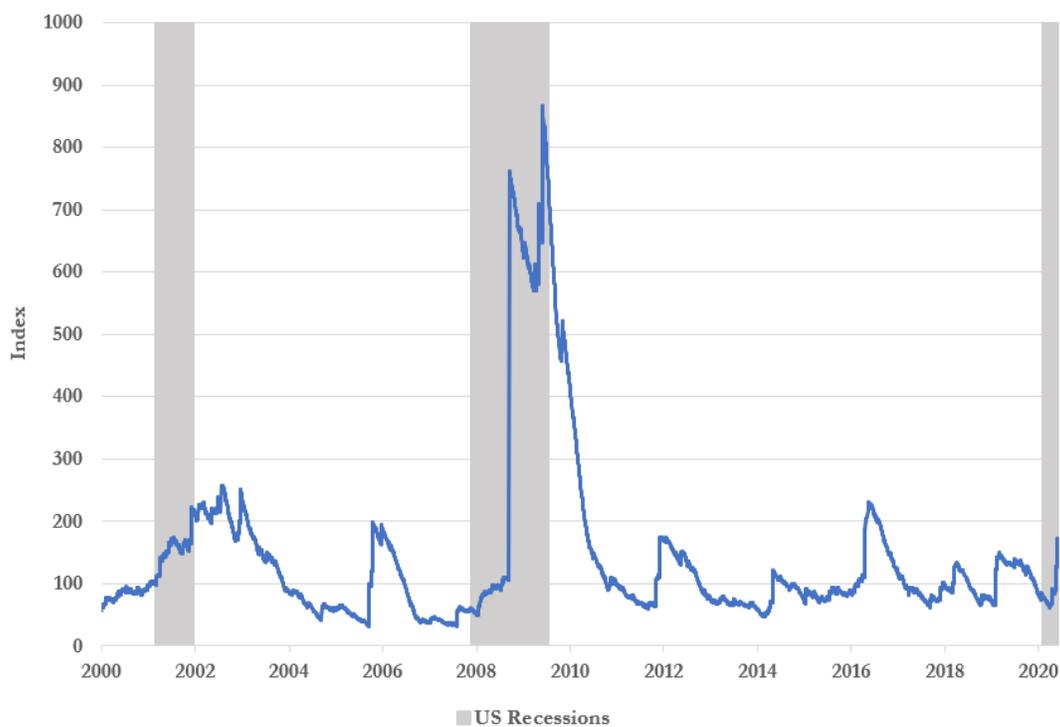
### **Exhibit 7. Estimated Inhibited Job Creation by Suppliers Due to Reduced TCI Coverage**

2019 US Gross Output by Industry (\$ Billions)	\$37,807
2019 US Sales Covered by TCI (\$ Billions)	\$600
TCI-Covered US Sales as % of US Gross Output	1.6%
2019 US Private Employment (Millions)	129.1
TCI-Covered US Private Employment (Millions)	<u>2.0</u>
Estimated US Gross Output Inhibited (\$ Billions)	\$46
Projected Percentage of US TCI-Covered Job Losses	7.6%
US Job Creation Inhibited Due to Reduced TCI Coverage (Rounded to Thousands)	<u>155,000</u>

<sup>13</sup> See, e.g. Justin Scheck and Heather Haddon, "Restaurants Search for Funds to Reopen," *The Wall Street Journal*, June 17, 2020, p. B3.

In addition to these estimated shortfalls in production and employment, another risk to the US economy due to reduced TCI coverage is the potential surge of bankruptcy filings during the COVID-19 recession, and the output and job loss impacts of those events. A TCI policy provides policyholders with protection against nonpayment from the companies in financial stress and those that declare bankruptcy. With reduced TCI coverage, some insured companies – especially those in hard-hit industries like construction and consumer durables that have suffered the greatest cutbacks in insurance coverage (see Exhibit 5) – may suffer sufficient non-payment losses that are no longer covered by insurance that force these insured firms to file for bankruptcy, with attendant job losses.

**Exhibit 8. Bloomberg US Corporate Bankruptcy Index**  
(Equal Weighting of Number of Bankruptcies and Amount of Liabilities)



As it is, Exhibit 8 shows that the COVID-19 crisis already has triggered a rising trend of US corporate bankruptcy filings, including the bankruptcy or liquidation by 16 retailers and restaurant chains

so far in 2020.<sup>14</sup> Bankruptcy levels so far are nowhere near those recorded during the 2008-09 financial crisis, but we are only several months into the pandemic-induced recession. By the end of this year, and certainly by early next year, many more bankruptcies are certain, especially as more small companies take advantage of the new streamlined provisions of Subchapter V of Chapter 11 of the U.S. bankruptcy code, which the CARES Act temporarily, through the end of the March 2021, makes available to a larger class of firms than would have been the case had the pandemic not occurred.<sup>15</sup> Some of these business failures likely will be attributable to insurance coverage cutbacks, leaving insured companies exposed to much greater bad debt losses than what would be the case had insurers not been compelled by events to reduce their coverage limits.

## **VI. A Time-Limited Government Reinsurance Proposal**

Given the key role that TCI plays in global and domestic trade, governments in other developed economies have partnered with private credit insurers in developing public backstop reinsurance programs to support the industry, and thus its policyholders and the global supply chain. Indeed, more than twenty countries, including most G-7 countries, have adopted or are exploring government-backed reinsurance on a temporary basis to empower the TCI industry to continue to provide much needed coverage to global businesses during the COVID-19 crisis.<sup>16</sup>

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<sup>14</sup> Businessinsider.com, as of June 1, 2020, available at <https://www.businessinsider.com/retailers-filed-bankruptcy-liquidation-closing-stores-2020-2>.

<sup>15</sup> Under the Small Business Reorganization Act of 2019, which went into effect in February 2020, a new Subchapter V under Chapter 11 of the US Bankruptcy Code applies to debtors with non-contingent, liquidated debts (secured and unsecured) totaling not more than \$2,725,625. The new subchapter V reduces the cost and time required for small businesses to complete a bankruptcy filing. The CARES Act, however, lifts the debt threshold to \$7.5 million for bankruptcies declared by March 27, 2021, which should induce more firms to take advantage of the liberalized provisions of Subchapter V than otherwise would have been the case.

<sup>16</sup> For an excellent overview of the backstop arrangements for TCI insurers in other countries, see Vladimir

One particular type of reinsurance – a *quota-share* arrangement – has been adopted in Belgium, Denmark, Germany, the Netherlands and the United Kingdom, and is being considered in Luxembourg, Norway and Romania. Under a quota share, the private sector and the government split losses by a fixed percentage, with the private insurers doing the marketing, underwriting and claims processing. While the reinsurance program is in effect, the government, in turn, receives *market-determined* premiums for extending the reinsurance, minus reimbursement of insurer’s costs of extending TCI coverage.<sup>17</sup>

There are several features of the quota share approach.

First, government participation in these times of extraordinary uncertainty, if structured properly, can reverse most of the insurance coverage cutbacks that threaten the strength of the recovery.

Second, because private insurers would continue to have their own “skin in the game,” they would have market-driven incentives, even with government reinsurance backing, to continue prudent underwriting of coverage, which mitigates the moral hazard and asymmetric information issues that are commonly associated with any government program.

Third, because private insurers would be doing the underwriting and continue to be at risk, the market would set premiums and insurers would pay claims, dispensing with the need for the government to perform both these functions.

Fourth, continued private sector participation would help minimize the cost to the government of providing reinsurance.

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Gololobov, “Backstops Here!” *Leaders Edge*, June 23, 2020, <https://www.leadersedge.com/p-c/backstops-here>.

<sup>17</sup> There are two other types of government reinsurance: “top-up” which would have the government extend coverage to current policyholders on a buyer-specific basis on top of existing insurance coverage ceilings on individual buyers, and “stop loss” which would put a ceiling on TCI insurers’ aggregate claims losses. Both of these approaches would require the government, and not the market, to set a price for the reinsurance – a process fraught with practical and political drawbacks – which would not be true for a quota share arrangement. For this reason, we do not discuss the other two reinsurance variations here.

The three insurers supporting this study have proposed a time limited reinsurance program that would be in place initially from March 1, 2020 through the end of this year, but capable of being renewed, depending on the nature and magnitude of pandemic-related economic risks (which should be driven primarily by the availability and wide deployment of an effective vaccine). Under the proposed program, private insurers would bear 10 percent of the risk of buyer non-payment from March 1, 2020 through the end of 2020 (with the possibility for extension if needed), with the federal government bearing the remaining 90 percent. Insurers would receive 10 percent of the premiums collected for the risks they cover and approximately another 32 percent of the premiums to reimburse insurers for their costs of administering the insurance (comparable to the costs of TCI insurers operating in other countries where government reinsurance is in place or being considered).<sup>18</sup> The federal government would collect the remaining 58 percent of the insurance premiums to help finance the risk it would be bearing.

In principle, the government could step in and simply restore coverage that TCI insurers have reduced, or just backstop the SME suppliers themselves. But the government, as an outsider, lacks experience and resources in assessing credit risks of millions of businesses across every step of the supply chain. Providing some kind of a reinsurance backstop, especially with a revenue and risk-sharing partnership scheme with the private TCI sector, is a far more cost-effective way of addressing the cutback in private sector TCI coverage and its ripple effects of supply chain disruptions and job losses.

A time-limited government backstop for TCI insurance during this time of the COVID-19 crisis would help retain and strengthen the competitiveness of U.S. businesses that are competing with foreign competitors backed (or soon to be backed) by government reinsurance. Moreover, a temporary reinsurance program would have positive long run economic effects by helping to keep innovative startups

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<sup>18</sup> The 32 percent of the overall premium is calculated as the product of the 90 percent of the total premium that is ceded to the federal government (matching the 90 percent risk assumed) and the 35 percent of “ceded premium” for insurer costs for which the government would reimburse the insurers (technically 31.5 percent, rounded up).

alive that otherwise would not survive or would have to curtail their growth. In the absence of government reinsurance, the U.S. economy that has already slid into a recession would be denied, conservatively, \$46 billion in gross supplier output and the creation of 155,000 jobs at supplier firms.