Meeting the “invisible banks”

Speech by Koen J.M. van der Veer*

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*Economist at the Economics & Research Division of the Dutch central bank. If you would like more information about this speech, my research findings, or possible venues for future research, please contact me via e-mail at k.j.m.van.der.veer@dnb.nl or call +31(0)20 524 5836.

My personal webpage can be found at http://www.dnb.nl/en/onderzoek-2/onderzoekers/overzicht-persoonlijke-paginas/dnb257546.jsp

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Executive summary

In the past two years, I have had the opportunity to study unique data on the worldwide activities of a private trade credit insurer. My findings show that private trade credit insurers not only facilitate but also stimulate trade. Every euro of trade covered by private trade credit insurers generates more than two euro in overall trade. In a way, private trade credit insurers work as “invisible banks”; while they don't provide funding, their actions influence buyers’ access to supplier credit, generating extra trade.

After the bankruptcy of Lehman Brothers, private trade credit insurers inevitably reduced their supply of insurance. A tentative calculation suggests that between 5 and 10 percent of the world trade collapse, and between 10 and 20 percent of the fall in European exports, was due to the lower appetite to cover exports. But what counts, is that private trade credit insurers survived the worst economic crisis since World War Two without financial support, and thus proved that their business model is sound.

The European Commission is conducting an evaluation of the state support schemes that were introduced in the second half of 2009. Active involvement by private trade credit insurers in this evaluation process could benefit the effectiveness of future schemes, thereby limiting future losses to insurers and the European economy.

Scientific research on the benefits of trade credit insurance at the level of the firm is still missing. As a result, the “who, why and what” of trade credit insurance is not widely known. More research would improve public understanding of the important role of private trade credit insurers in the world economy, and add to their reputation.
Ladies and gentlemen,

Ever since the outbreak of the financial crisis, researchers around the world have focused their attention on the influence of financial institutions on the real economy. Banks in particular have become really popular study material. For example, since the crisis, more than 170,000 scientific articles were published on banks. Pension funds got the attention in almost 9,000 articles. Insurers in more than 15,000. And private trade credit insurers... one article, by one researcher. And this article is not even cited much. In fact, it has been only cited twice; once by myself, and once by a friend of mine…. No surprise that your industry is nicknamed ‘the invisible banks’.

That wouldn’t be so bad if that nickname had not proved to be contagious. It makes me ‘the invisible economist’. At least at social gatherings. Of course I try to pimp my profession and my subject, but it’s like selling ice to the Eskimos.

That’s why speaking here today – although it feels a little like putting my head in the lion’s mouth – is a real treat. Because today I am surrounded by people who don’t only know what a private trade credit insurer is, but who also think – know – that it is a very worthwhile, very important, profession. Today I might be able to talk about this fascinating industry for about 20 minutes without losing the attention in the first thirty seconds. And that is not only because you know what I am talking about, but because I think I really have some things to tell you…

Although they are not all things you might like to hear…In all honesty, I think that part of my speech will anger you and part of my speech will annoy you, but there is also a part – the first part – that will please you. I will start with that.

As credit insurers, world trade is important to you. But did you know that you are twice as important to world trade than world trade is to you? Did you know that for every euro of trade that you cover, you generate more than two euro in overall trade? Did you know that you do not only facilitate but also stimulate trade? And that you do that by a factor greater than 2?

You do know now. Because that is the main outcome of my research. I am aware of the saying that an economist is a man who states the obvious in terms of the incomprehensible. But I assure you that this outcome is the result of three basic ingredients: a large dataset, a good economic model, and a tough supervisor.

First, the dataset. The activities of trade credit insurers span the globe, and my dataset covers the worldwide activities of one of the ‘Big Three’ insurers. For example, I know that in 1992, this
insurer covered exports from the United Kingdom to Afghanistan with a value of 85 thousand euro, received premiums of 11 hundred euro, and paid out claims of more than 43 thousand euro with a zero recovery rate. But also, I know that in 2006, this insurer covered Dutch exports to Germany with a value of 6.5 billion euro, received premiums of almost 9 million, and paid out claims of 6 million with a recovery rate of 12%. All in all, I studied trade flows between more than 4 thousand country pairs, over a period of 15 years.

I studied these trade flows by using a widely accepted economic model of trade: the second ingredient of my research. This model accounts, for example, for the fact that the penetration rate of credit insurance is much higher in Europe than in the United States. It also accounts for the fact that the demand for credit insurance differs between various stages of a country's business cycle. And finally, it accounts for changes in economic, financial and political conditions in all buyer countries. In more general terms, the model controls the demand for credit insurance, and estimates the impact on trade of a change in the supply of credit insurance.

The final ingredient of my research was a tough supervisor from a top university. During all stages of this project, I was supervised by Andrew Rose. He is a Professor at the University of California, Berkeley, and one of the world's leading economists. My basic result was promising, he said, but show me that the multiplier is present in all markets and all time periods. So I examined the trade multiplier of credit insurance for various sub samples of my dataset. I dropped different years from the dataset and still found that you stimulate trade by a factor greater than 2. I dropped different countries, and again found that a change in covered trade causes a two times bigger change in overall trade. And finally, I dropped whole continents, and once more found a multiplier greater than 2.

But what causes this trade multiplier? Why is it that you generate additional trade on top of the value of the trade flow that you insure? The answer can be found in my new ‘bible’: the recently published handbook on credit insurance by Paul Becue, a general manager at Euler Hermes. This is his argument: whenever you change a buyer's credit limit, this news tends to travel fast among all suppliers of the buyer, including the uninsured suppliers, and potentially influences all of the buyer's trade transactions. So an upgrade of a credit limit generally improves the buyer’s access to supplier credit, which generates extra trade. Whereas a downgrade of a credit limit generally reduces the buyer’s access to supplier credit, which causes trade to fall. Thus, private trade credit
insurers work as invisible banks – yes, that’s where you got the nickname –; while you don't provide funding, your actions influence buyers’ access to supplier credit.

In short, my research results provide the macroeconomic evidence for Becue's notion of ‘invisible banks’. Whenever you approve or increase a credit limit, you do not only facilitate trade between your client and the buyer but also stimulate trade between the buyer and its other suppliers. By a factor greater than 2.

OK, that was the pleasing part of my speech. The next part might make you angry….

After the collapse of Lehman Brothers, you substantially reduced your supply of insurance. As a result, you contributed to the collapse of world trade. To soften the blow: your contribution to the trade collapse was economically relevant, but relatively small. Of course, me being an economist and not a politician: this is an observation, not a judgement. Of course you want to know how I got to this observation. Based on the statistics from the Berne Union I calculated that export sales insured by private insurers declined by some 23% in the three quarters after the collapse of Lehman Brothers. In the same period, exports sales covered by short term credit insurance from public export credit agencies, declined by less than 7%. Obviously, both reductions in cover were influenced by demand and price factors. However, only the decline in private cover was also influenced by supply considerations. Therefore, the difference between the decline in public and private cover gives a rough estimate of the drop in exports covered by private insurers that was supply driven. This difference amounts to some 16 percentage points in the third quarter of 2009 and more than 20 percentage points in the final quarter. Given the uncertainty of these numbers, I use a more conservative range in my final calculation, and assume a supply driven decline in covered exports by private insurers of 10 to 20%.

Based on the decline in covered exports, the trade multiplier, and the share of world exports that you cover, I calculated that between 5 and 10% of the world trade collapse was due to your lower appetite to cover exports. Since most of your outstanding exposure is in Europe; your contribution to the collapse of European exports was about twice as high, between 10 and 20%.

No, not very nice to hear. Of course, there is uncertainty around these numbers, so I’m sure that you will give me a hard time defending them. And that's OK. These are estimations, not indisputable facts. I have presented these calculations at international financial institutions such as the ECB, the EBRD, OECD, the IMF and the World Bank, so I have had my share of criticism.
For example, some of you might say that during the crisis, the multiplier was absent. Some of you might say that during the crisis, everything was different. Perhaps. But I did not observe nor believe this. What I observed was much stress among suppliers and buyers when they were confronted with reduced or canceled credit limits in a time when they needed this cover the most. In this respect, the commotion here in the Netherlands was telling. And more so, I don't believe that, during a crisis, the influence of a limit reduction on the suppliers of a buyer is absent, or smaller. On the contrary, such a negative signal on the creditworthiness of a buyer is likely to be even more important during a crisis and the influence of the limit reduction on trade possibly even bigger.

Either way, in the end, the whole discussion about the true size of your contribution to the world trade collapse is history and therefore academic. What counts is the experience itself and how you dealt with that in real time. And I believe that your decision to reduce and cancel credit limits was fully justified. After the collapse of Lehman Brothers; capital costs rose, reinsurance capacity became scarce, and claims were bound to rise to unprecedented levels. So you took action. And – even more important – you survived. Where other financial institutions across the world had to be rescued, you survived the worst economic crisis since World War Two, without financial support. This shows that the tough decisions that had to be taken, were taken, and that your business model is sound.

But as you are recovering from the credit crisis by trying to get back the clients that you lost, and trying to keep the clients that survived the crisis without having to file a claim, you face, yet again, a slowing world economy and a highly uncertain economic environment. Especially in your key market, Europe.

Which brings me to the final part of my speech, the annoying part. Because the annoying truth is that you need European governments more than you are willing to admit. Like most entrepreneurs, you don’t like government involvement. And - in normal times - that's a healthy state of mind. But these are not normal times. Uncertainty is high and you can't risk losing many clients or reducing your cover by double-digits again. In the years ahead, you need to secure a stable premium income at an acceptable level of risk, and that's where you can benefit from cooperation with the state, or better yet, the European Commission. If well organized, of course.
As we all know, the state support schemes introduced in the second half of 2009 were not well organized, and generally ineffective. They were not coordinated at the level of the European Union, were implemented after the damage was done, and did not have a clear exit strategy. As a result, for many of you, these schemes were probably more a burden than an opportunity to limit your costs of the crisis.

But imagine. Imagine a supporting scheme that is coordinated at the level of the European Union, so you will save time and resources discussing different schemes in different countries. Imagine a scheme that becomes available before you have to drastically reduce your cover, so you can limit your loss of clients and limit the damage to your reputation. Imagine a scheme with a clear exit strategy, so you can recover your market share as soon as the conditions allow you to do so.

While it might be hard to imagine a scheme with these characteristics, it is not so hard to imagine a crisis in which you would actually need such a scheme. As we speak, the European Commission is conducting an evaluation of the state support schemes. In fact, the deadline for your contribution to this evaluation is tomorrow. ICISA already shared its view on behalf of you, and perhaps you have done so by yourself too. But it’s much better to stay involved. To invest time in building the right scheme now, so you will limit your losses later. That means contributing actively to the following stages of the evaluation process of the state support schemes. So in the end, there will be a scheme that can do for you, what you do for your clients; help them survive this economic storm and emerge stronger.

That is what you need. That is what you need to do. In my humble opinion of course. What I need is to finish my PhD, and in order to do that I need more data. Or more precise: I need your data. The obvious question is: what’s in it for you? Quite a lot. If I can finish and publish my thesis, the who, why and what of trade credit insurance will be more widely known. Maybe people will even stop asking why there is such a thing as trade credit insurance in the first place. Maybe you will no longer be nicknamed ‘the invisible banks’. Because then my thesis will provide the scientific evidence for the benefits of trade credit insurance at the level of the firm. My thesis will then show that credit insured firms suffer less from liquidity shortages, have lower earnings volatility, and have better access to receivables financing. So, in the coming weeks I will contact you, and if you give me access to your data, we will create a classic win-win-situation. Maybe even by a factor greater than 2….

Thank you.