A CRISIS GONE TO WASTE...

Why did we not learn the policy lessons from the pandemic?

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About Theia Finance Labs

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Theia Finance Labs (formerly 2° Investing Initiative Germany) is an independent, non-profit think tank incubating research solutions for the financial sector that help solve the climate crisis. The Theia Finance Labs name is inspired by the Greek goddess of sight, the light of the blue sky, and the value of gold, Theia, and by the Greek word Aletheia, which means “disclosure” or “truth”, literally “the state of not being hidden”. The new brand thus mirrors our goal to develop evidence-based research and tools that shed light on the intersection of finance, climate change, and long-term risks. Theia operates as a 100% non-profit organization.

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A note about this chart pack:

The analysis provided in this chart pack build on the previous report from Theia Finance Labs (2021) „Corporate Rainy Day Funds“ and use exhibits, analysis, and texts. This chart pack is thus a complementary publication to the publication, updated for clarity, scope, and new analysis and findings as relevant and appropriate.

READ OUR 2021 REPORT ON THE CONCEPT OF A “CORPORATE RAINY DAY FUND” HERE.

The Covid-19 pandemic triggered the most significant corporate bailout in modern economic history.

Within a few months of the pandemic, governments announced over $4 trillion in public corporate bailouts, excluding health care spending and direct transfers.

By 2023, the US government alone spent over $4 trillion across all COVID-19 relief. While there is some debate as to the size of the bailout when considering central bank balance sheet use during the Global Financial Crisis, taking a fiscal view makes it clear that the bailout of the COVID-19 pandemic was unprecedented.

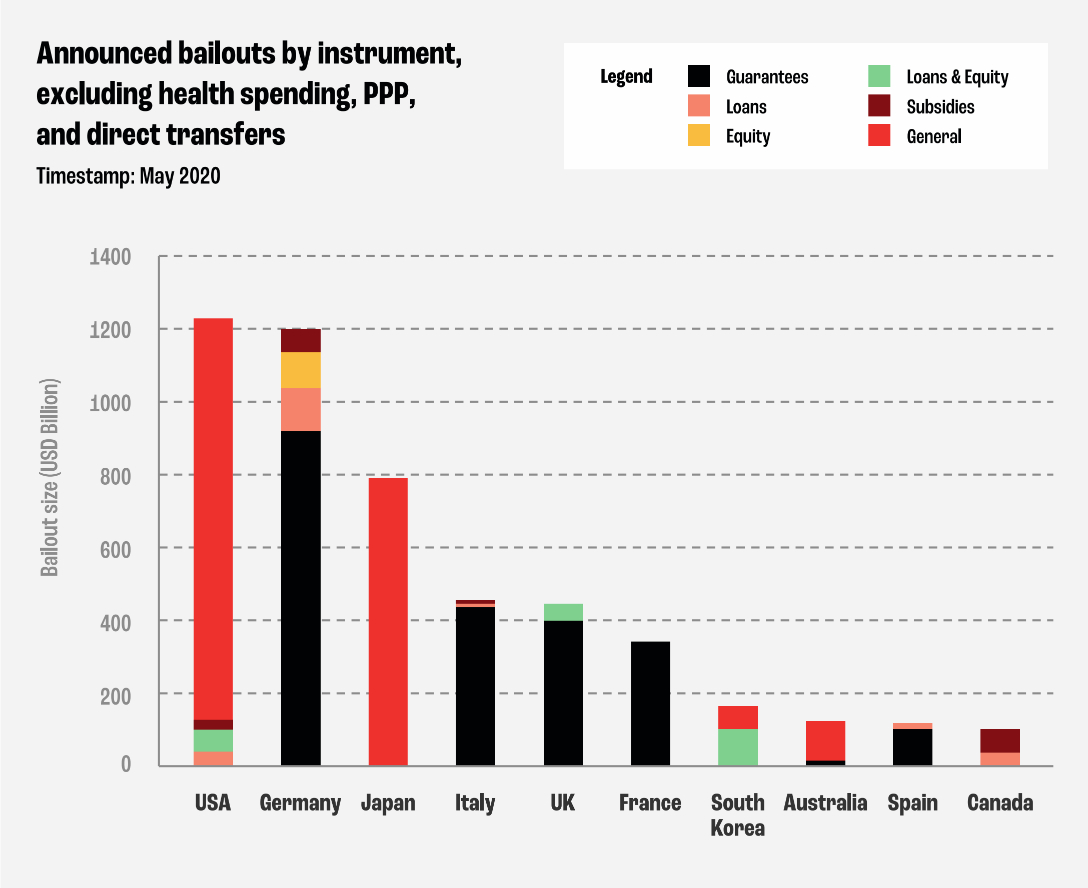
Despite this historical unprecedented bailout, the debate about policy reform to improve corporate resilience post pandemic effectively did not take place.

While the Global Financial Crisis triggered a range of policy reform designed to strengthen the financial system, arguably with meaningful impact. It is uncontested that banks today are more resilient to shocks than they were in 2007 by the simple merit of holding more capital and having more stringent risk controls (recognizing that does not make them safe from failure entirely, as a range of recent examples demonstrate). This policy reform was not perfect, but ultimately ambitious in scope and meaningful in the extent to which they changed the underlying regulatory reality.

More than three years on from the pandemic, it seems clear that it represents "a crisis gone to waste".

This is a critical lost opportunity. In a "polycrisis" world exposed to "exponential risks" (in the words of Moody's), corporate resilience is more important than ever. Fiscal balance sheets are significantly weakened from the previous bailout and may not have the capability for a repeat. As a result, successful economies must put measures in place to prepare for the next crisis.

This note identifies the three biggest missed opportunities for reform taking the lessons of the pandemic into account: business interruption insurance, force majeure clause regulation, and shareholder buybacks.



The polycrisis era needs a new relationship with bailouts

Bailouts create significant liability for the dynamic between the public and private sector. They are truly a last resort and should be treated as such.

Bailouts can represent a significant economic burden on government budgets, even if in some cases governments can recover a significant percentage of their outlays, depending on broader conditions. They undermine public trust in equitable policymaking. They may violate broader policy objectives. They may create moral hazard for businesses that are “too big to fail”. Their use should therefore only come after all other options are truly exhausted.

there is reason to believe that the frequency and scale of “1 in 1000” types of mega risks may increase in the coming decades. This implies that future bailouts are perhaps more, not less likely unless private sector resilience is enhanced.

A combination of factors is amplifying the exposure of society, the economy, and financial markets to new types of risks that are likely to amplify the likelihood and scale of future economic and financial crises. These drivers include technological disruption, social tipping points (in particular those driven by environmental risks), climate and nature risks, and the broader increase in conflicts. Some of these are highly predictable. Whereas COVID-19 can be described as an exogenous shock, companies that don’t adopt climate targets will likely amplify an abrupt “Inevitable Policy Response” that will in turn cause disruption and economic dislocation. Lack of financial resilience can create political pressures for governments to trigger a “high-carbon bailout” -- potentially delaying the transition.

Crucially, policy measures were put in place after the latest Global Financial Crisis to strengthen the financial resilience of financial institutions, while limited measures were put in place for corporates, reducing the overall resilience of non-financial companies when the pandemic materialized. Despite this reality, a range of resilience issues remain largely ignored by policymakers.

The two key determinants of future bailouts are operational and financial resilience of economic actors

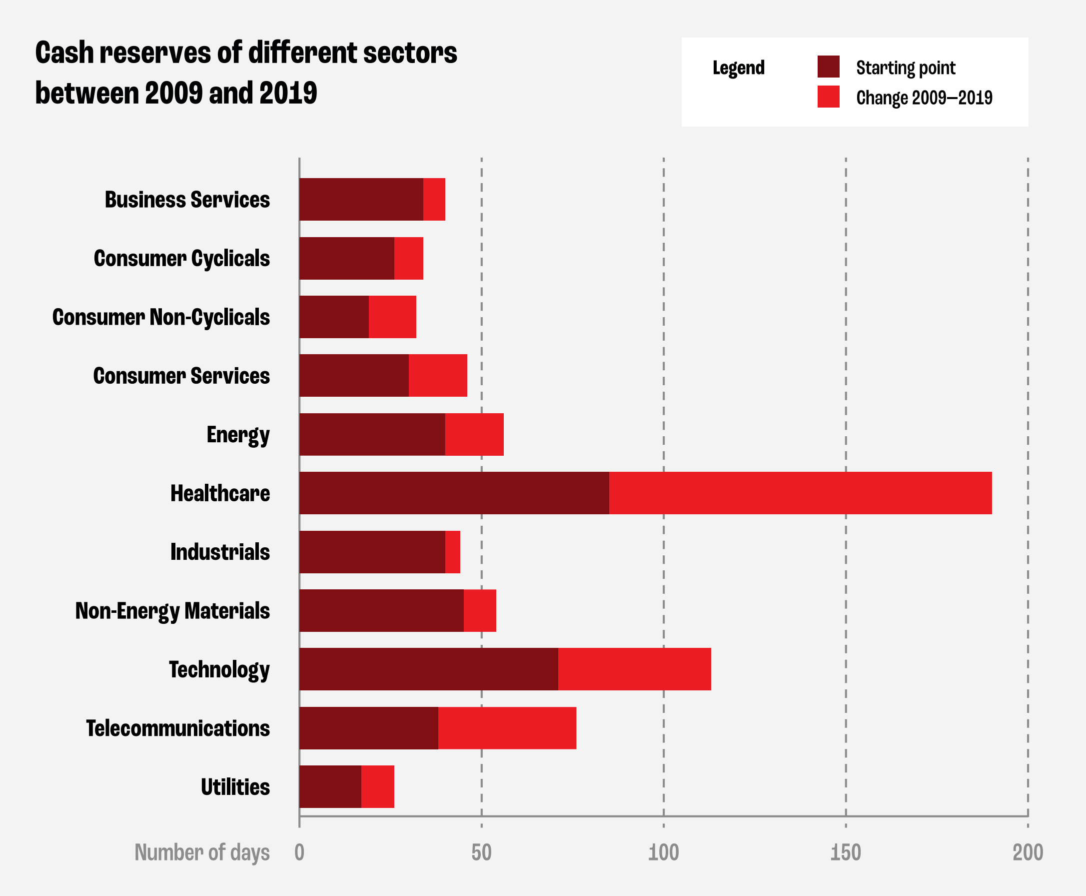
"Resilience" or preparedness of companies can be considered from the vantage point of "operational resilience" (that is, the resilience of the business model and the corporate assets) and "financial resilience" – the resilience of the balance sheet.

Operational resilience includes a range of aspects across the company's business. It extends to the *ability* of the company to produce and sell its products and services in the presence of the risk. A new era of risks obviously requires changes in thinking about the types of events companies need to be resilient against.

Financial preparedness or resilience, in turn, focuses on the strength of the corporate balance sheet to weather challenges to business continuity and operational resilience. Financial resilience effectively ensures the viability of a company where operational resilience breaks down temporarily. It allows companies to adjust their business and production model (e.g. investing in new supply chains, new production modes) and / or overcome business and production interruption, where the underlying model may be sound, but short-term factors create a breakdown of operational resilience (e.g. lockdown during a pandemic).

One way to think about financial resilience is cash reserves, although there are of course other factors, including access to capital, insurance, etc.

This report focuses on the "financial preparedness" of companies and identifies three "missed policy opportunities" to strengthen financial preparedness in response to the COVID-19 pandemic.



Three key policy reforms for financial resilience

Business interruption insurance was not widely in place and did not work effectively as a first 'loss taker'

- Regulatory frameworks harmonizing and clarifying business interruption insurance provisions
- Legal requirement for business interruption insurance (potentially modelled after the Federal Deposit Insurance Cooperation model)
- Payout schemes ensuring the quick processing of insurance claims

Despite a 'profit boom', corporate cash reserves remained in aggregate incredibly low at just over 1 sales month

- Capital market reform addressing the practice of shareholder buybacks and more broadly the ability to 'extract rent' out of companies in boom times, including the potential introduction of "capital requirement" equivalent policies for non-financial corporates

Lack of clarity around Force majeure clauses in contracts create both legal bottlenecks and lack of clarity on contractual obligations in a crisis

- Regulatory or market standards harmonizing definitions around "force majeure"

#1: Mandatory business interruption insurance (1/2)

In theory, business interruption insurance is designed to ensure financial resilience. In practice, it is unclear how usable this is for pandemic-style risks.

A key challenge for business interruption insurance is the extent to which pandemic style events actually allow companies to trigger the business interruption insurance clauses. A particularly egregious example of how this might play out is the case of the German insurer Württembergische Versicherung. A number of insurance policies sold by this company actually list in its “additional conditions” the types of viruses and diseases covered in the case of a business interruption. By design, any new virus thus is not covered, even if “pandemics” or disease-related events are covered (Jöhnke 2020). As a result, the insurance company advised that its business interruption insurance claims would not be paid out, since the SARS-COV-2 virus was not listed.

Moreover, the majority of companies don’t actually have business interruption insurance.

While data on the actual coverage of business interruption is limited, survey data in the United States shows that only one in three small businesses had business interruption insurance, based on a survey of 500 small businesses (Insurance Journal 2015). Of course, the coverage is likely to be much higher for larger companies relevant in capital markets, especially given the extent to which business interruption insurance is mandatory in some loan contracts.

Interestingly, there is evidence from the UK that the current dynamic around this insurance makes it less attractive, given the sense that the insurance won’t pay out anyway. In a survey by McKinsey covering 500 small UK companies, one-fifth said they would stop paying for the insurance, while a quarter said they would stop buying two of them (Ralph 2020).

Even if business interruption insurances exist, legal ambiguities in clauses may make pay-outs complex.

Given the lack of data on liability insurance contracts, it is difficult to impossible to measure the extent to which individual risk categories may or may not be covered by business interruption contracts. Moreover, even if they are covered, the ambiguity of language and finesse of language – as seen in the case of the German insurance company – will still potentially lead to rejection of claims. At the point where the legal question is settled, it may be too late for many businesses requiring financial support. As outlined by Dizard (2020) in a recent Financial Times article, “*These are not really separate logical and legal arguments being crafted by skilled professionals with the dedication of master shoemakers. All the cases come down to the ambiguities in interpreting badly written business interruption insurance policies.*” According to Allianz (2015) statistics, it can already take more than 100 days from losses of the company to the payment of insurance companies in the engineering sector, for example. This, despite the fact that over 50% of these insurances refer to an apparently simple event such as fire and explosion (see figure on next page).

#1: Mandatory business interruption insurance (2/2)

In summary, a review of insurance products currently suggests that they are – at least in their current form – not well adapted to mega risks.

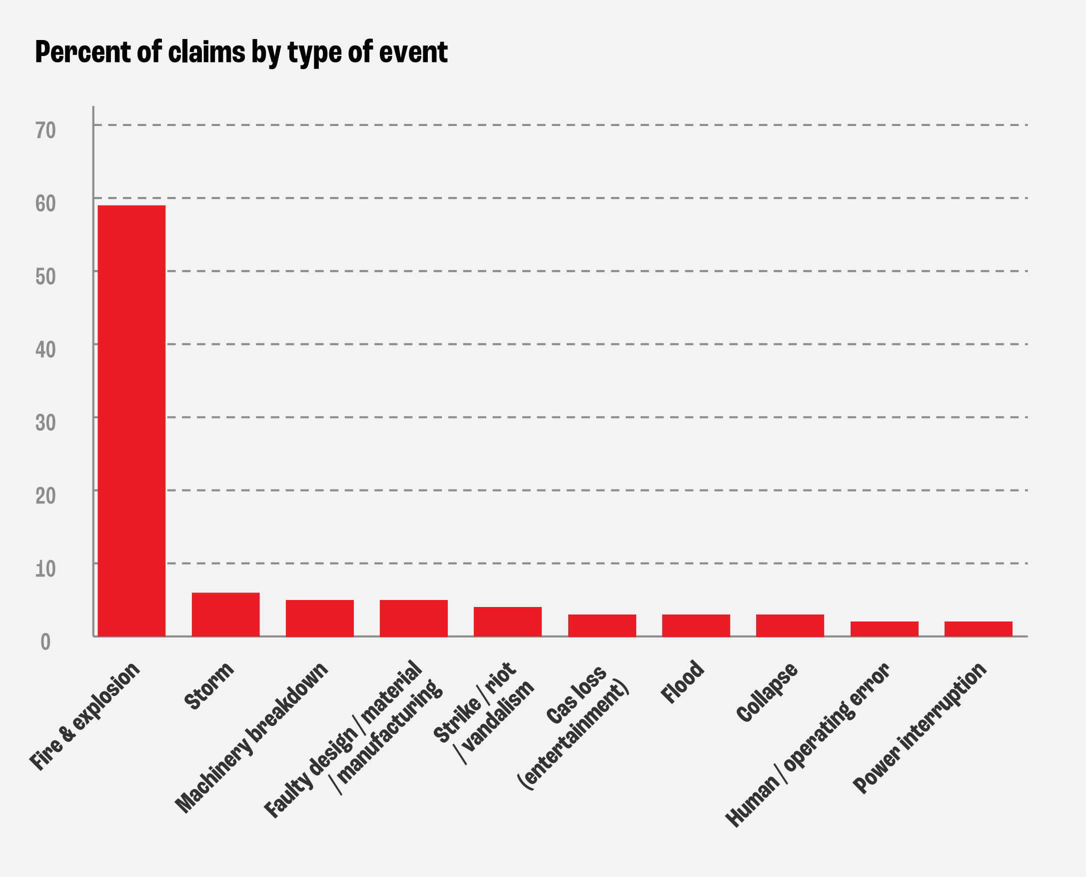
Ambiguous clauses lead to conflicts when settling claims, which will delay payment. These are likely to be particularly pronounced for insurance cases, with broader ambiguities on policies and when they trigger, notably business interruption. On the consumer side, “income protection insurance” ranks third in percentage of claims rejected, according to EIOPA (2017).

Delayed payments jeopardize the underlying philosophy of the insurance because they then don’t address potential liquidity issues and increase business uncertainty. In this context, these types of insurance products may in some cases strengthen operational resilience by ensuring that operations are “insured”, but not “financial resilience” given delays in payment.

That is not to say that insurance products cannot be viable as a mechanism in the context of mega risks. Indeed, most of the proposals outlined in the next section represent in one way or another an “insurance product”. However, as currently designed, they are not well suited for these risks.

Finally, it should be noted that even if insurance products work, mega risks are systemic, which challenges the premise and the business model of insurance.

The viability of an insurance sector exposed to systematic claims of business interruption insurance is a question mark. Even re-insurance may be challenged in an environment where the whole world makes a claim. As financial resilience increases for corporates, it may come at the expense of financial resilience for insurance companies.



#2: Force majeure (1/2)

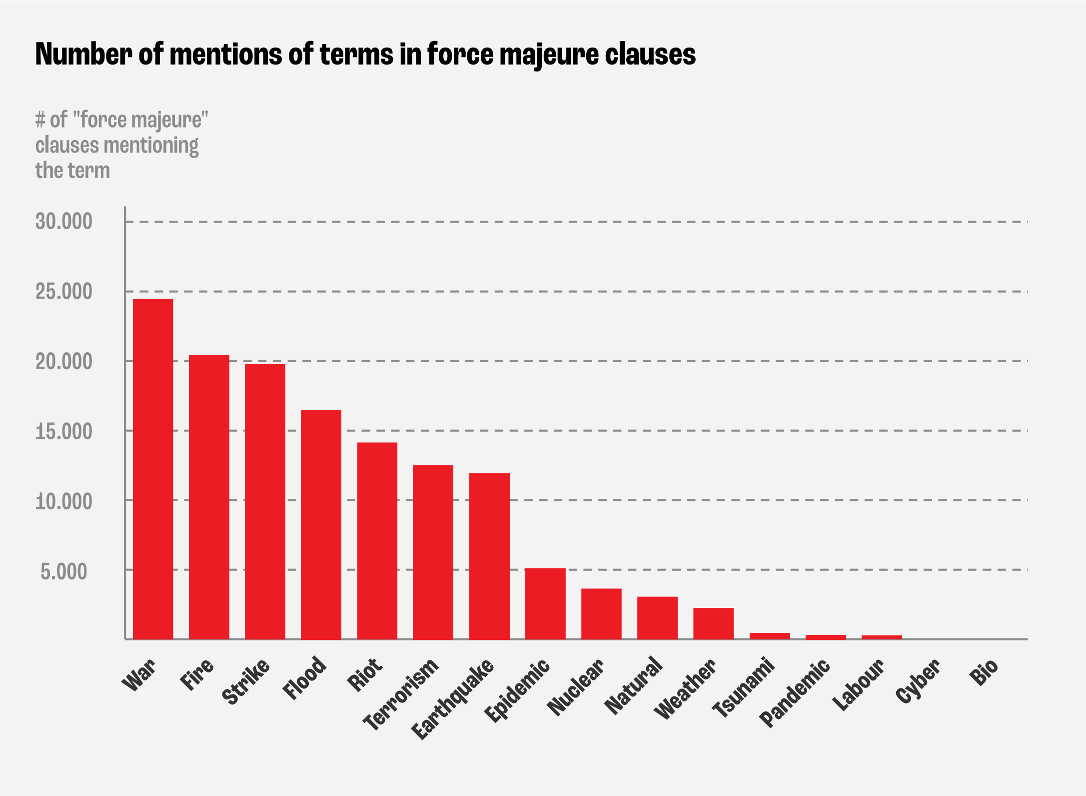
Force majeure clauses or "hardship clauses" represent opportunities for contractual exits.

According to NortonRose Fulbright (2020), and it is worth quoting at length here: "…the concept force majeure has its origins in French law where there are express provisions in the French civil code which excuse contractual performance where events have happened outside the parties' control which could not have been foreseen at the time of contracting and which could not have been avoided by appropriate measures. It can also operate to exclude a claim for damages. However, force majeure is not a standalone concept of English law. Under English law, contractual performance will be excused due to unexpected circumstances only if they fall within the relatively narrow doctrine of frustration. This doctrine will apply by default unless the parties agree on something else in their contract." In other words, either the concept is not specifically defined, or parties define certain events specifically to clarify the scope of "force majeure".

When looking at "force majeure" clauses in contracts, their phrasing and scope suggests that the actual implementation of these clauses is highly unclear.

As part of research published in 2021, we looked at a sample of 34,451 publicly available contracts from the LawInsider Database, which contain "force majeure" clauses Across the 34,451 contracts that contained such clauses, 338 "types" of clauses could be identified. In other words, the language of "force majeure" clauses in these contracts could be clustered in a limited number of categories. The chart to the right highlights how many clauses mention specific events. The most frequent citation is war, represented in over 50% of force majeure clauses as a specific case. Of course, a large minority of clauses do not further stipulate which kind of events fall under the force majeure category.

The wide variety of different "standard clauses" in contracts is striking. Around 7% of clauses mention no specific risks. 53 of the 34,451 clauses mention at least twelve different types of risks. The distribution between these two extremes is roughly normal, with most clauses mentioning between 3-6 risks.



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#2: Force majeure (2/2)

The analysis demonstrates the ambiguity of these clauses and the extent to which they can – and will be – contested in court when these risks materialize.

If a force majeure clause, for example, doesn't mention terrorism, does terrorism count as force majeure? While some argue for more detailed descriptions, they risk falling into the trap of creating lists that are exclusive rather than inclusive. As a result, the ability to exit "mega risks" may not actually exist, depending on the phrasing of the force majeure clauses.

As outlined by leading US law firm Paul Weiss (2020), "COVID-19's classification as a "pandemic" by the WHO will trigger a force majeure clause that expressly accounts for "pandemics." That said, the declaration of pandemic standing alone—without a reference to pandemics in a force majeure clause—will not automatically constitute a force majeure given the courts' focus on whether the event is specified within the contractual language. Clauses that are silent on pandemics, epidemics, or other viral outbreaks are likely to be insufficient for a force majeure defense due to COVID-19, unless, of course, courts liberalize the force majeure analysis to account for market realities."

Moreover, even if "contractual exits" exist, they at best provide incomplete support for financial resilience.

Force majeure clauses may allow businesses to cut costs from their suppliers, rents, and other payments, but they don't capture all types of outgoings, notably labor that – even under some layoffs – still represents a cost. Moreover, as outlined above, they also represent a risk to businesses as contractual guarantees may be lost. The contractual exit creating resilience for one company may be the death knell of another. In sum, both in the way they are currently applied and as a concrete mechanism, force majeure clauses are incomplete in driving the financial resilience of companies.

Finally, contractual exits are a "micro" source of resilience, with a winner and a loser.

They are thus a source of resilience for an individual company, but also a source of risk for the counterparty relying on the contractual payment commitments to operating their business. As a result, this mechanism does not seem relevant for further analysis in terms of policy support, although it seems clear that the better articulation of these clauses – also in the spirit of avoiding protracted litigation driven by poorly written clauses – is a worthwhile endeavor for private sector actors and can also reduce uncertainty. However, it is unlikely to overall address the challenge of pivoting from bailouts as a first to bailouts as a last resort.

#3: Cash

There is a range of literature demonstrating the importance of strong corporate balance sheets and in particular cash for financial resilience.

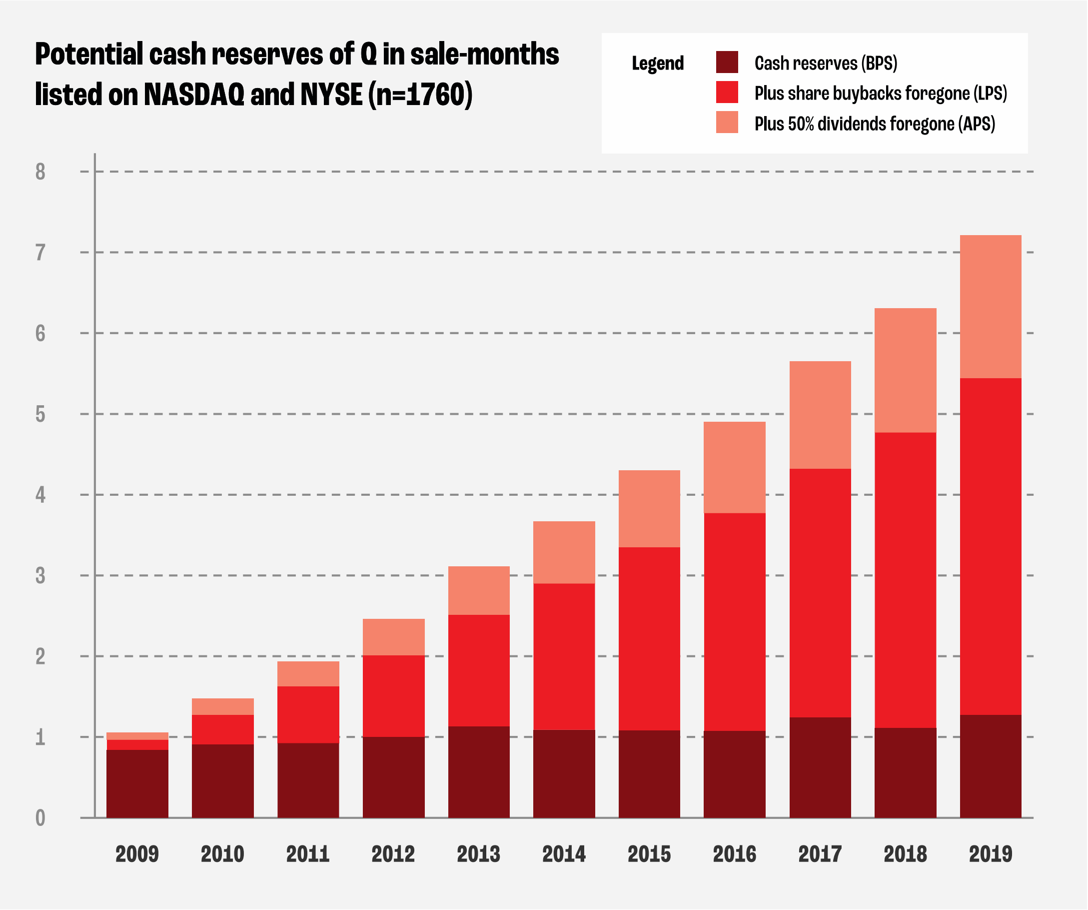
Preliminary evidence suggests that "corporate debt and cash holdings emerged as the most important value drivers" (van Horen 2020). A significant body of literature demonstrates the importance of liquidity for valuations and risk, in particular during the current COVID-19 crisis (Acharya and Steffen 2020, Fahlenbrach et al. 2020). Financial resilience concerns both the "corporate value" and of course the underlying solvency and liquidity structures of the company. Those two are not only important for investors but also for citizens engaged in pensions and insurance products, as well as a personal investment. More resilient companies reduce the destruction of human and physical capital associated with bankruptcies.

In analyzing financial resilience related to "mega risks," we look at cash reserves of a sample of 1,430 companies listed in the New York Stock Exchange and NASDAQ.

The cash reserves in this report are presented as cash over sales. This metric gives a sense of how liquid companies are in case of a "lockdown". Of course, the indicator has some shortcomings. During a lockdown, businesses may only lose 50% instead of 100% of sales, in which case the actual cash reserves last longer than the metric would suggest. Sales may be stable but profits negatively due to unexpected costs, which create financial difficulties.

Across the universe of companies analyzed, since the financial crisis, cash reserves have increased only marginally, from covering 24 days of sales to 39 days of sales, although differences are significant across sectors.

Crucially, if companies would have been more conservative with their cash, they would have had over 7 months of cash reserves across the analyzed sample. While we recognize the economic cost that would have had in terms of 'idle cash', it would have significantly reduced the requirement for government bailout and thus the "extraction of rents" in an upturn and the "socialization of risks" in a downturn.



A new policy world…that so far remains untapped

The COVID-19 pandemic is a "crisis gone to waste" as meaningful reform to corporate resilience was not actioned and in fact little discussed. Key lessons from the pandemic in terms of flaws in the system remain unaddressed.

While there have been some legislative efforts in some jurisdiction to address the particular corporate resilience to pandemics (notably through dedicated reform of business interruption insurance as it pertains to pandemics in the United States, or with regulatory reviews of business interruption insurance (e.g. UK Financial Conduct Authority), these have not actually translated into meaningful policy reform. Moreover, they remain largely focused on pandemic specific issues and don't address the broader challenges around corporate resilience in a world of 'exponential risks'. This report focuses in particular on the policy opportunity set related to strengthening financial resilience across three key policy areas.

- **Business interruption insurance was not widely in place and did not work effectively as a first 'loss taker'**
  - Regulatory frameworks harmonizing and clarifying business interruption insurance provisions
  - Legal requirement for business interruption insurance (potentially modelled after the Federal Deposit Insurance Cooperation model)
  - Payout schemes ensuring the quick processing of insurance claims
- **Despite a 'profit boom', corporate cash reserves remained in aggregate incredibly low at just over 1 sales month**
  - Capital market reform addressing the practice of shareholder buybacks and more broadly the ability to 'extract rent' out of companies in boom times, including the potential introduction of "capital requirement" equivalent policies for non-financial corporates
- **Lack of clarity around Force majeure clauses in contracts create both legal bottlenecks and lack of clarity on contractual obligations in a crisis**
  - Regulatory or market standards harmonizing definitions around "force majeure"

We recognize the significant remaining questions around implementing these policies and the need for a thorough cost-benefit analysis to evaluate their applicability. This report does not provide such a full cost-benefit analysis. While such a cost benefit analysis may change our interpretation of ideal policy pathways, it is clear that policy action across each of these areas is necessary.

There are serious flaws identified in the extent to which these policy areas can support corporate financial resilience and a massive opportunity for international engagement and cooperation on a collective response to these challenges. What is more, it is clear that that increased corporate financial resilience is necessary in the era of exponential risks.

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