

Professors increase the strength of banks

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'New financial instrument makes state aid for banks unnecessary in the future'

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"The capital requirements for banks are not enough to ensure financial stability." That was the message from Jaime Caruana, General Manager of the Bank for International Settlements, this week at a meeting of central bankers in Sydney, Australia. In his opinion, regulators should play a greater role in limiting risks in the financial world.

The list of proposals to limit the next crisis is growing. Higher capital requirements, lower bonuses and no proprietary trading are the most frequent suggestions. 'Unfortunately the regulatory discussion is often motivated by populism,' says Theo Vermaelen of INSEAD. 'To keep the voters satisfied the thumbscrews are being tightened.'

But that, according to Vermaelen and his colleague Christian Wolff of the University of Luxembourg, has major disadvantages. The different rules in various countries lead to unfair competition. "What is more, worldwide, there are more than 100,000 regulators. And they also couldn't prevent the current crisis", according to Wolff, "That gives little hope for the future."

According to both professors, it is important to take the building up of banks' capital as a starting point in the prevention of a next crisis. By incorporating disciplined mechanisms into this build-up of capital, the likelihood of taxpayers paying for the problems in the financial world will be decreased and a so-called 'moral hazard' will be avoided in many cases.

This is why Vermaelen and Wolff recently designed a new financial instrument in the area of contingent convertibles: the COERC (Call Option Enhanced Reverse Convertible). In the terms of this loan the bond holders are obliged to exchange their loan for shares if the share price falls under a predetermined level. The aim being that it reinforces the banks capacity in times of need.

The convertible bond is automatically converted into an ordinary share at a very low conversion price of, for example, EUR 1. But unlike a regular convertible bond, the shares are not delivered to the holders, but are held in escrow. In accordance with the terms of such a loan, this process begins when the stock rate is under pressure, and decreases for example to under EUR 5 or less.

After the conversion, the shareholders have the possibility (option) to buy the new shares for a certain period of time at the same price as they were converted. Since the price is probably much lower than the actual stock rate, the majority will, according to Wolff and Vermaelen, make use of that right. But if they do not have money for this, they will, over time have the possibility to sell this option on the market.

"With the money that this delivers, the holders of debt securities are repaid", says Christian Wolff. "In this way the risk of non-payment to bond holders is significantly reduced. With this proposal they get their money returned even if the bank is suffering."

For the bank it means that in times of emergency the equity on the balance sheet in relation to the borrowed capital increases automatically. In this way the solvency improves without long negotiations. When a bank is about to go under, speed is of the utmost importance in restoring the confidence of the financial markets.

According to the two professors, their proposal has important advantages compared to a normal convertible bond, whereby creditors will only proceed with the conversion when the share price rises. In other words, if things go well, the

balance sheet is strengthened with its own equity," says Vermaelen. "With our instrument, this only happens when the bank has problems and the solvency needs boosting."

"Obviously, the share price falls at the end of the operation," says Wolff. "But the shareholders also have more shares. It does not matter whether they have one share of EUR 5 or five shares of EUR 1. The capital position remains the same. "

"We are trying to save capitalism," says Vermaelen. "The regulators and politicians appear nowadays to be limiting the way the system functions. It is as if they are throwing the drowning man they have just saved back overboard because they didn't like the looks of him."

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