Too-Big-to-Fail Shareholders

Yesha Yadav, Professor of Law, Vanderbilt Law School

Presentation to the National Stock Exchange, Aug 2019
Motivation

• Post-Crisis consensus relies on capital regulation to ensure that financial firms operate safely and have the cushion needed to fail in an orderly fashion.

• Pre-Crisis, failing investment banks were over-leveraged and under-capitalized.

• The disorderly collapses of leading financial institutions showcased the need for a robust regulation and focus on strengthening bank balance sheets.

• A great deal of emphasis is now on banks raising common equity.
U.S. Banks and Write-Downs

- A number of banks saw massive write-downs during the Crisis and sharp falls in the value of their equity:

Source: Bloomberg

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>130.4</td>
<td>-82.46%</td>
</tr>
<tr>
<td>Wachovia</td>
<td>101.9</td>
<td>-88.34%</td>
</tr>
<tr>
<td>Bank of America</td>
<td>97.6</td>
<td>-67.79%</td>
</tr>
<tr>
<td>JP Morgan</td>
<td>69.0</td>
<td>-31.51%</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>55.9</td>
<td>-85.16%</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>47.4</td>
<td>-10.77%</td>
</tr>
</tbody>
</table>
U.S. Bank Capital Buffers Pre-Crisis

• Most U.S. banks were regarded as well-capitalized prior to the Crisis and had capital buffers much in excess of Basel’s 8% ratio of capital to risk-weighted assets.

• The Top-20 U.S. banks averaged an average capital ratio of 11.6%.

• Post-Crisis criticisms argue that the quality of bank capital was sub-optimal: did not include enough Tier 1 Equity: pure capital to absorb bank losses and assist resolution.

• U.S. banks had taken on exposures that were too complex and large to be sustained by their levels of capital.
Turn to Equity Post-Crisis

• The post-Crisis consensus has seen a marked turn to common equity as the protective bulwark against crippling losses and too-big-to-fail.

• Equity offers blunt and ready protection against generalized risks that can affect a bank. Scholars like Admati and Helwig have proposed equity buffers of around 20% of RWA.

<table>
<thead>
<tr>
<th>Capital Requirements Basel III/Federal Reserve</th>
<th>% Equity Buffer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Equity Tier 1</td>
<td>4.5% (4.5% + 1.5% Tier 1)</td>
</tr>
<tr>
<td>CET Countercyclical Capital Buffer</td>
<td>0-2.5%</td>
</tr>
<tr>
<td>CET Capital Conversation Buffer</td>
<td>Greater than 2.5%</td>
</tr>
<tr>
<td>CET G-SIB Surcharge (U.S. version)</td>
<td>1-4.5%</td>
</tr>
</tbody>
</table>
Who Supplies the Equity?

• U.S. capital markets have undergone deep institutionalization since the 1960s-70s.

• Rather than investing individually, U.S. homes and businesses instead invest through funds and asset managers like BlackRock, Vanguard, Fidelity or State Street.

• These firms have evolved to become the largest pools of capital. Funds run by these firms invest money for homes, businesses and financial firms across U.S. capital markets.

• They are also extremely powerful shareholders in corporate governance.
Key Asset Managers

• BlackRock is the biggest shareholder in the world. It manages around $6.5 trillion dollars in assets – more than all hedge funds and PE funds put together.

• Vanguard manages more than $5.2 trillion in assets globally and Fidelity around $2.7 trillion.

• BlackRock reportedly has investments in almost all listed companies in the U.S., and indeed has an enormous footprint around the globe.

• BlackRock also runs Aladdin, an operating system that helps direct around $11 trillion worth of investments based on its risk analytics.
Common Ownership

• Antitrust economists have pointed to a rise in pervasive “common ownership” in U.S. capital markets.

• Common ownership or “horizontal shareholding” (Elhauge) describes the phenomenon of a small number of shareholders occupying blockholder positions in different companies in the same industry.

• For these economists, the rise of common ownership, becoming entrenched since the gradual institutionalization of the market points to higher costs, less competitive service.

• Banking is singled out as industry where common ownership is dominant.
Survey Results

• I looked at the largest publically traded U.S. banks to examine their major blockholder providers of equity capital. I excluded banks whose head office is located outside U.S.

• Out of the 26 banks examined in 2017, 25 included both Vanguard funds and BlackRock funds as holders of more than 5% of their common equity.

• Vanguard and BlackRock were also holders of more than 5% equity in the holding companies of financial infrastructure providers: ICE, NASDAQ, CME and CBOE Holdings.

• State Street held over 5% equity in 12 bank holding companies; Fidelity in six bank holding companies; and T. Rowe Price in five companies.
Block Ownership of Banks: Proxy Statements 2017

<table>
<thead>
<tr>
<th>Asset Manager</th>
<th>Number of Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>BlackRock</td>
<td>25</td>
</tr>
<tr>
<td>Vanguard</td>
<td>25</td>
</tr>
<tr>
<td>State Street</td>
<td>12</td>
</tr>
<tr>
<td>Fidelity (FMR LLC)</td>
<td>6</td>
</tr>
<tr>
<td>T. Rowe Price</td>
<td>5</td>
</tr>
</tbody>
</table>
Block Ownership of Banks: Proxy Statements 2011

- **BlackRock**: 10
- **Vanguard**: 1
- **State Street**: 1
- **Fidelity (FMR LLC)**: 7
- **T. Rowe Price**: 0

Blockholder: Asset Manager
## Utility Companies

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CME</td>
<td>7.6%</td>
<td>5.6%</td>
<td></td>
</tr>
<tr>
<td>ICE</td>
<td>6.1%</td>
<td>5.8%</td>
<td>9.0%</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>7.3%</td>
<td>6.0%</td>
<td></td>
</tr>
<tr>
<td>CBOE Holdings</td>
<td>7.19%</td>
<td>6.91%</td>
<td>11.83%</td>
</tr>
</tbody>
</table>
Rationale

• This makes sense. U.S. banks have been hungry for equity capital since 2007-8. They have raised over $400 billion dollars worth in equity capital.

• These large equity managers represent the deepest and most abundant pools of capital in the economy.

• Investing in BHOs might be said to represent a strategy to garner exposure to a swath of the broader economy through bank lending decisions.

• In the last couple of years, bank revenue has performed well, with large profits reported.
Governance Challenges

• The dominance of common owners as big blockholders in the vast majority of large, systemically important banks poses governance risks:

  ➢ Bank information is notoriously opaque. Short-term creditors are generally information-insensitive.

  ➢ Bank shareholders are also notoriously risk-seeking because they can use banks’ cheap access to debt to generate high-velocity returns.

  ➢ Maybe, by being systemic blockholders, these incentives may be pronounced.
Total Assets, All Commercial Banks

Shaded areas indicate U.S. recessions

Source: Board of Governors of the Federal Reserve System (US)  fred.stlouisfed.org
Governance Benefits

• Asset managers tend to be passive shareholders. They depend on a low-fee model of investment.

• They may therefore be less prone to the bad incentives that afflict shareholders.

• Their expense in information and activism may generate wider benefits.

• Certainly, their passiveness may also leave risky instances of activism unchecked.
Solutions
Broader Future Questions for SIFI Resolution

• The goal of the DFA and post-Crisis rulemaking has been to get rid of the TBTF problem.

• However, the pervasive appearance of large blockholders creates deep links between the real economy.

• Banking losses may be especially massive for fundholders if panics create macro-prudentially wide impact.

• Should asset managers do more for bank governance?

• Intersection of financial regulation v. antitrust. Is there a tension?