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

Bank	Credit Losses & Write-Downs (Billions) (Jun 2007-March 2010)	Equity Return (June 2007-Dec2008)
Citigroup	130.4	-82.46%
Wachovia	101.9	-88.34%
Bank of America	97.6	-67.79%
JP Morgan	69.0	-31.51%
Merrill Lynch	55.9	-85.16%
Wells Fargo	47.4	-10.77%

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.

Capital Requirements Basel III/Federal Reserve	% Equity Buffer
Common Equity Tier 1	4.5% (4.5% + 1.5% Tier 1)
CET Countercyclical Capital Buffer	0-2.5%
CET Capital Conversation Buffer	Greater than 2.5%
CET G-SIB Surcharge (U.S. version)	1-4.5%

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.

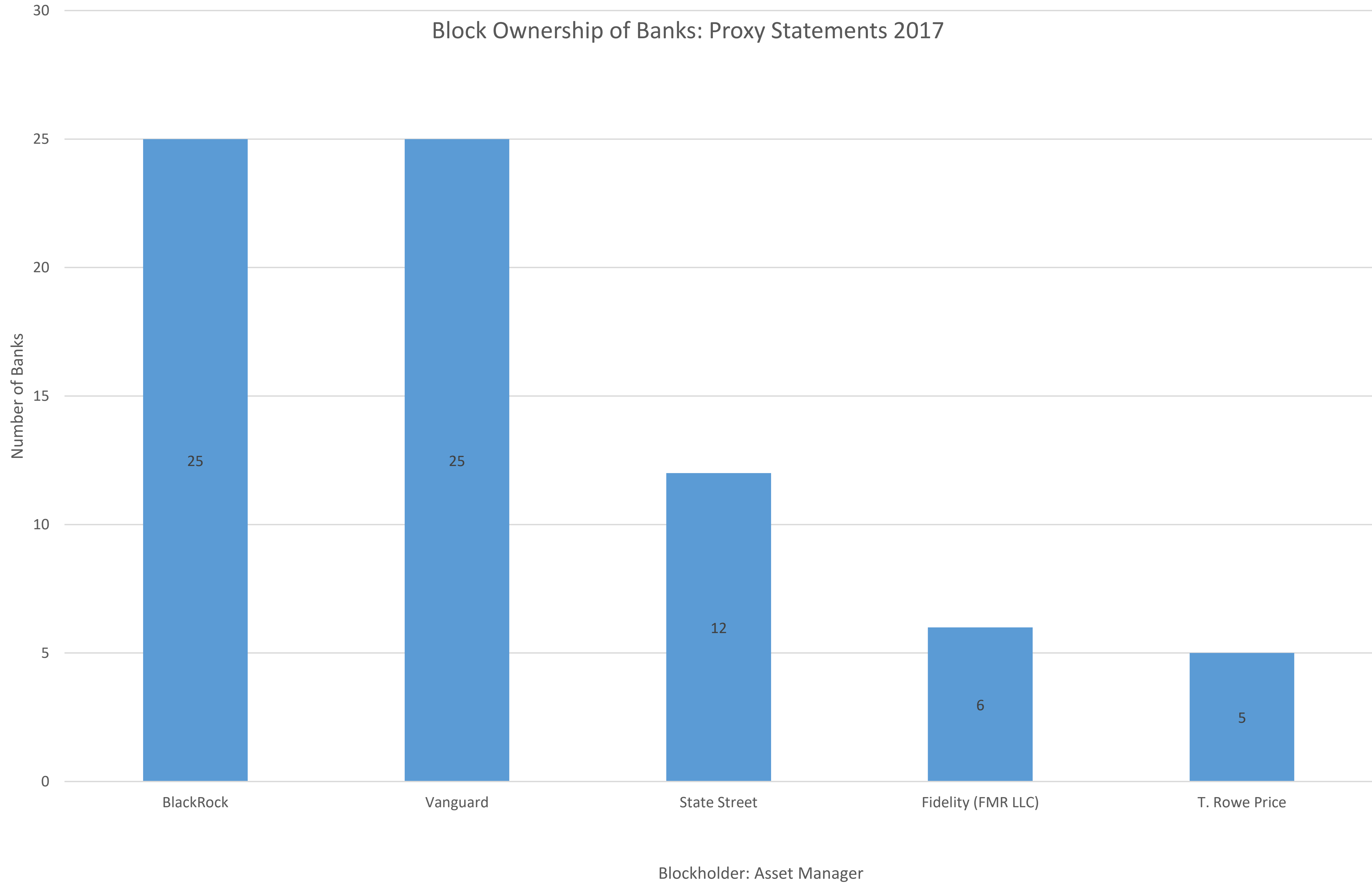
Survey Results

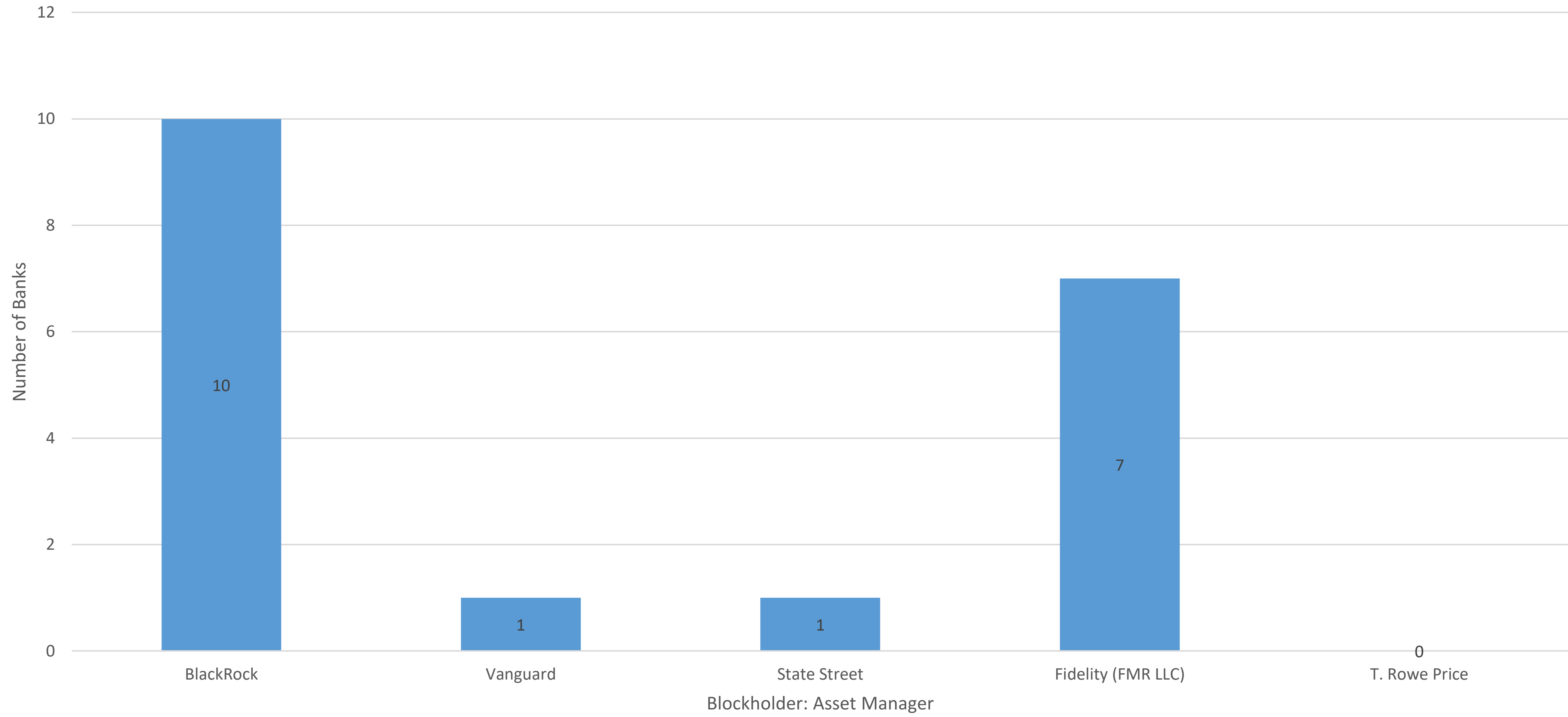
- I looked at the largest publically traded U.S. banks to examine their major blockholder providers of equity capital. I excluded banks whose head office is located outside U.S.

- 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
30
25
20
15
10
5
0
Number of Banks
25
25
12
6
5
BlackRock
Vanguard
State Street
Fidelity (FMR LLC)
T. Rowe Price
Blockholder: Asset Manager


Block Ownership of Banks: Proxy Statements 2011
12
10
8
6
4
2
0
Number of Banks
10
1
1
7
0
BlackRock
Vanguard
State Street
Fidelity (FMR LLC)
T. Rowe Price
Blockholder: Asset Manager

Utility Companies

Utility Holding Company	BlackRock Ownership (2016)	Vanguard Ownership (2016)	T. Rowe Price
CME	7.6%	5.6%	
ICE	6.1%	5.8%	9.0%
NASDAQ	7.3%	6.0%	
CBOE Holdings	7.19%	6.91%	11.83%

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.

WILLIAMSON
22
ANZ
MUNRO
82

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.

FRED — Total Assets, All Commercial Banks

Billions of U.S. Dollars

18,000
16,000
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0

1975 1980 1985 1990 1995 2000 2005 2010 2015

Shaded areas indicate U.S. recessions

Source: Board of Governors of the Federal Reserve System (US)

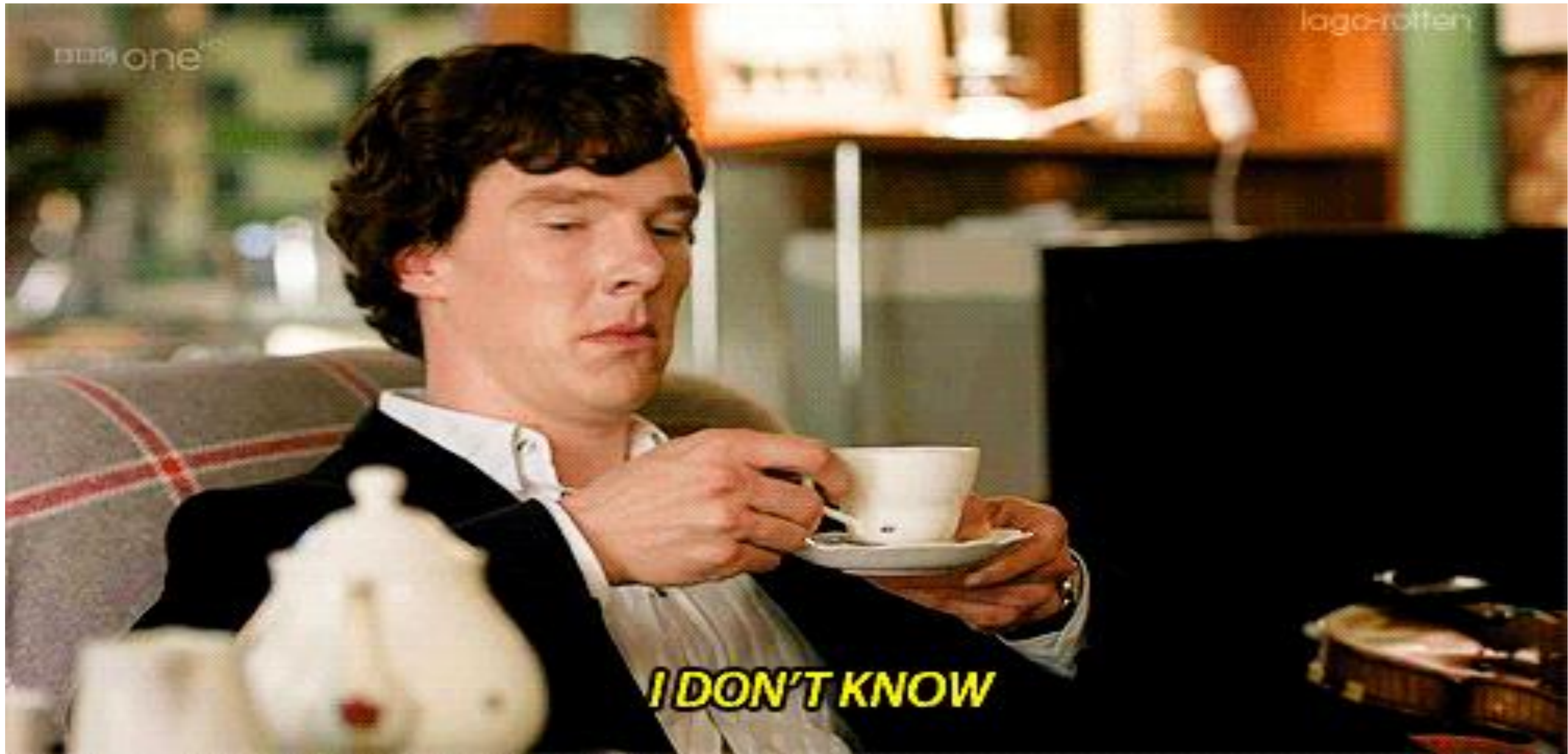
fred.stlouisfed.org

stories

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?