The Common Equity Problem in Bank Regulation

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IGIDR EMF Conference 2017
Motivation

• Banking regulation has been subject to enormous transformation since the 2008-Financial Crisis.

• Now well known, banks suffered catastrophic losses in 2008-2010 and regulators around the world responded with a slew of measures.

• Through the Basel Committee on Banking Regulation and Basel III, regulators have sought to (i) increase capital buffers with much more equity; (ii) ensure greater liquid reserves; and (iii) eliminate too-big-to-fail through orderly liquidation procedures.

• The Dodd-Frank Act implements this consensus by ramping up required capital buffers and liquidity reserves, mandating stress tests and introducing Title II’s OLA.
World’s biggest bank losses
2008, $bn

Royal Bank of Scotland
Citigroup
Wells Fargo
Fortis
UBS
HBOS
Credit Suisse
Deutsche Bank
Hypo Real Estate
Bayerische Landesbank
Dresdner Bank
Merrill Lynch Bank USA
Norinchukan Bank*

Source: The Banker
*Year to March 31st

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>
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<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>
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<tr>
<td>Bank of America</td>
<td>97.6</td>
<td>-67.79%</td>
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<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>
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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>
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<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 $4.9 trillion dollars in assets – more than all hedge funds and PE funds put together.

• Vanguard manages $3.5 trillion in assets globally and Fidelity around $2.06 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 providers of equity capital. I excluded banks whose head office is located outside U.S.

• Out of the 25 banks examined, 22 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 eight bank holding companies; Fidelity in 7 bank holding companies; Berkshire Hathaway and T. Rowe Price in four companies.
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 quarters, bank revenue has performed well, with large profits reported. Though, by and large, banking has been volatile and unprofitable since 2010.
Risks – Ex Ante

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

  - On the one hand, they may have information advantages by dint of common ownership across banking. However, bank information is notoriously opaque. Short-term creditors are generally information-insensitive.

  - Errors in interpreting this information may be compounded across the banking industry. Will shareholders factor in the macroprudential component into understanding risks?

  - Fund managers are well known for being passive investors – and activism in banking is difficult and expensive.

  - Will this create incentives to give a wide berth to managers? Is there a danger that, the lower the value of the bank franchise, the more pervasive the incentive to risks at creditor expense (e.g. correlation seeking, Richard Squire) (Dividends, Acharya).

  - Co-ordinated action possible?
Risks Ex-Post

• 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.

• The loss of equity capital in the event of a bank collapse is likely to make a dent in the value of funds representing accumulated retail and corporate savings. The exercise of the OLA will similarly eliminate equity value in the event a bank fails.

• The losses may be especially massive if panics create macro-prudentially wide impact, extending to market infrastructure.

• Are bailouts inevitable if equity is likely to be especially hard-hit?
Solutions
Some Ideas

• Corporate governance duties for shareholders (see, David Min’s awesome paper!)

• A greater focus by FSOC or the Fed to push shareholders to be more effective guardians of the capital they supply.

• Should large blockholders set aside some capital themselves to bolster the value of their funds in the event of a banking collapse. This would reduce returns yet further.

• Create a priority mechanism within CET 1 equity pool, potentially imposing losses on investors placing their own capital at risk, versus asset managers investing household capital. Is this workable? Violates equal treatment?