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We Need to Know Who Invests in Bank Equity

*Yesha Yadav**

Over the course of 2016 and 2017, as Monte dei Paschi di Siena, Italy's oldest and fourth-largest bank, teetered on the brink of collapse, national regulators fretted about triggering processes designed to make it easier and less chaotic to wind down failing financial institutions.[1] Following the financial crisis, regulation requires banks to issue securities—in the form of both equity and bonds—intended to help absorb losses and buffer a bank's reserve of funds to pay off short-term creditors and depositors in a crisis.[2] In the case of Monte dei Paschi, a swath of its junior bondholders were directly in line to suffer losses. As the bank neared a point of crisis, these bonds could be triggered to transform into equity, reducing the debt burden on the bank's books.[3] Moreover, this injection of equity could also release value to help pay off senior creditors and depositors. In short, private investor capital would absorb the risk of bank collapse rather than require taxpayers to provide an expensive bail out.[4]

In this instance, however, this well-laid plan ran into a problematic hitch: the bondholders were ordinary middle-class Italians,

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1. *EU Clears Italy's $6 Billion State Bailout for Monte dei Paschi*, REUTERS (July 4, 2017, 8:44 AM), https://www.reuters.com/article/us-eu-montepaschi-stateaid/eu-clears-italys-6-billion-state-bailout-for-monte-dei-paschi-idUSKBN19P1PQ [https://perma.cc/7LL9-338U]; Giovanni Legorano & Julia-Ambra Verlaine, *Italy Eyes Exemption to Spare Monte Paschi Bond Holders*, WALL ST. J. (Dec. 23, 2016, 5:39 PM), https://www.wsj.com/articles/italy-eyes-exemption-to-spare-monte-paschi-bond-holders-1482516483 [https://perma.cc/TNY5-4SUV].

2. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203 §§ 202(a), 206, 124 Stat. 1444, 1459 (2010) (shareholders are last to be paid out and are thus wiped out); *see also* David A. Skeel Jr., *Single Point of Entry and the Bankruptcy Alternative* 2–3 (Penn L.: Legal Scholarship Repository, Paper No. 949, 2014), http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1949&context=faculty_scholarship [https://perma.cc/GZM2-VGB2].

3. *See* Christos Hadjiemmanuil, *Monte dei Paschi: A Test for the European Policy Against Bank Bailouts*, OXFORD BUS. L. BLOG (May 2, 2017), https://www.law.ox.ac.uk/business-law-blog/blog/2017/05/monte-dei-paschi-test-european-policy-against-bank-bailouts [https://perma.cc/9F8S-ZKYB].

4. Hadjiemmanuil, *supra* note 3.

not brand-name financial institutions.[5] Could everyday "mom and pop" investors be expected to pay the price for a bank's risk taking? What would be the political fallout of impoverishing the savings of ordinary Italians in order to protect the banking system? In the end, the decision of Italian authorities was telling. Rather than force losses on retail bondholders, the government stepped in with a rescue package in the amount of €5.4 billion ($6.1 billion USD).[6]

Monte dei Paschi offers a cautionary example of what is at stake for regulators in seeking to solve the problem of too-big-to-fail banks. Post-crisis regulation requires banks to maintain thicker capital buffers—reserves of assets available to better ensure that banks can pay off depositors and other short-term creditors to prevent a crisis at one bad firm from spreading to others within the financial system.[7] Following the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), banks must fund these buffers much more fully by issuing equity as well as bond securities designed to take losses in the event a bank is close to full-blown crisis.[8] With deep reserves of equity and high-risk, loss-absorbing bonds, banks have larger stores of available value to pay off short-term creditors and depositors. In post-crisis regulatory design, bank equity holders and designated bondholders are tasked with maintaining bank safety and soundness, exposed to the default risk of bank failure.

But scholars and policymakers have not yet considered the question of who, in fact, invests in the risk-bearing securities critical to bank regulation and resolution—and what this means for regulatory policy. My research seeks to fill this gap, with the goal of understanding who really assumes the risk of bank failure across the U.S. financial system and whether they are realistically capable of bearing it. In examining these questions, the ultimate aim of this research lies in determining how the laws on the books may work in the messy and deeply political world of financial markets in crisis.

In my Article, *The Common Agency Problem in Bank Regulation*, I examine the block equity ownership of the twenty-five major U.S.

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5. Legorano & Verlaine, *supra* note 1.

6. REUTERS, *supra* note 1.

7. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Reserve Bd. Approves Final Rule to Help Ensure Banks Maintain Strong Capital Positions (July 2, 2013), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20130702a.htm [https://perma.cc/UZ7Q-HBTV].

8. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Reserve Bd. Adopts Final Rule to Strengthen the Ability of Gov't Auths. to Resolve in Orderly Way Largest Domestic and Foreign Banks Operating in the U.S. (Dec. 15, 2016), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20161215a.htm [https://perma.cc/RC6B-YX6D].

bank and financial holding companies deemed sufficiently important to the financial system to merit regular stress testing (as of June 2016) by the Federal Reserve.[9] Examining the 2011 and 2016 proxy statements of these banks, the results raise serious questions for policymakers. First, the Article shows that from 2011 onwards, in the years following the passage of the Dodd-Frank Act in 2010, these large U.S. banks have seen a marked rise in the number of blockholders—shareholders owning more than five percent of common equity—in their capital structures. In 2011, in what was then twenty-four U.S. firms in the group, these banks had an average of 1.45 equity blockholders.[10] Some banks had no equity blockholder at all. By contrast, in 2016, the picture had changed noticeably: the banks had an average of 3.02 blockholders, an increase of 110% in a relatively short period. At that time, each bank had at least one blockholder and twenty-four banks had more than one.

Crucially, the Article shows that a small group of shareholders constitutes repeat blockholders in the U.S. banking system. A cohort of asset managers—firms that specialize in managing the savings of homes and businesses by providing wealth management products like mutual funds—holds several equity blockholder stakes at U.S. banks.[11] BlackRock, Vanguard, Fidelity, State Street Global, and T. Rowe Price each have multiple equity block stakes across the largest U.S. banks. Per the 2016 proxy statements, BlackRock was a blockholder at twenty-three out of the twenty-five U.S. banks stress tested by the Federal Reserve, while Vanguard was a blockholder at twenty-two, Fidelity at seven, and both State Street Global and T. Rowe Price at four each.

These findings should give pause to regulators. Following the financial crisis, policymakers have placed enormous confidence in the capacity of thicker equity buffers to absorb the catastrophic costs resulting from the failure of one or more large and complex financial firms. Since the passage of the Dodd-Frank Act, however, a small group of key asset managers—representing the savings of main street savers and businesses—have assumed significant exposure to the most important and systemic U.S. financial institutions. In other words, retirement and other savings funds managed by BlackRock, Vanguard, and others mentioned above are deeply invested in securities designed

9. Yesha Yadav, *The Common Agency Problem in Bank Regulation* (Vanderbilt Law Research Paper No. 17-3, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2922681 [https://perma.cc/2JTF-H8XU].

10. In 2011, the Citizens Financial Group was a fully-owned subsidiary of the United Kingdom's Royal Bank of Scotland.

11. *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228 (2014) (discussing asset managers and regulation of mutual funds).

to take on the default risk of failing financial institutions and to be wiped out in order to maintain the overall functioning of the financial system.

This is not to suggest that these funds are doomed in the event of a financial crisis. For one, asset managers are generally careful to manage the risks to which their funds are susceptible, for example, by deploying diversification strategies.[12] Rather than investing just in bank equity, or in a single bank's equity, one might expect funds to instead be exposed to a combination of risk types that protects them against a sharp, concentrated loss. But some caution is nevertheless in order. Banks are not normal companies. They are special because banks are uniquely susceptible to instability and sudden collapse on account of a peculiar capital structure: banks owe money to depositors on demand,[13] but they lend money to borrowers on a long-term basis. A panicked rush by depositors to get their money out of the banking system can force banks to sell their long-term assets, call in loans, and stop lending to customers and other banks. More than any other type of company, by virtue of their special capital structure, banks can careen quickly (and sometimes unexpectedly) towards cash-flow and balance sheet insolvency.[14]

Importantly, banks often tend to fail together.[15] If an airline company loses money or suffers a crisis, its competitors might expect to pick up some of its business and see a corresponding rise in their share price.[16] Banks work differently. Because depositors may not be well positioned to know which bank is safe, they may (rationally) rush to get their money out of all big banks without waiting to see which one is really in trouble. In banking, even competitors can be dependent on each other's survival as a means of assuring their own. More broadly, a banking crisis can often trigger a larger malaise within the economy, where reduced bank lending causes a slowdown and causes businesses

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12. *See, e.g.*, *The Guide to Diversification*, FIDELITY.COM, https://www.fidelity.com/viewpoints/guide-to-diversification [https://perma.cc/X28Z-ZK7Y] (last visited Sept. 9, 2017).

13. That is, banks owe money to depositors whenever depositors want their money back.

14. *See* MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION (2016) (discussing panics in the financial system and their economic consequences); V.V. Chari & Ravi Jagannathan, *Banking Panics, Information, and Rational Expectations Equilibrium*, 43 J. FIN. 749 (1988); Douglas W. Diamond & Phillip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983).

15. HAL S. SCOTT, CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS (2016).

16. *See* Jen Wieczner, *United Airlines Just Dragged Up to $90 Million Off of Warren Buffett's Stock Value*, FORTUNE (Apr. 11, 2017), http://fortune.com/2017/04/11/united-airlines-stock-passenger-dragged-off-plane-warren-buffett/ [https://perma.cc/78WD-59GV].

as a whole to struggle.[17] Put more simply, investing in the equity of multiple large and interconnected banks presents risks that may not always be easy to diversify. While ultimately a matter for future research, fund investors face the risk that: (i) banks are inherently unstable as a function of their capital structure, (ii) bank failures can be contagious, and (iii) bank failures can often cause recessions that affect multiple types of businesses.

The proliferation of asset managers—BlackRock, Vanguard, Fidelity, T. Rowe Price, State Street Global—as repeat equity blockholders at banks raises numerous questions for financial regulatory policy: Are the savings funds they manage sufficiently resilient to withstand portfolio value being wiped out in the event of a large bank failure or multiple such failures? What kinds of losses might these funds face, taking into account possible exposures not just to equity, but also, for instance, junior bonds issued by risky banks? From the ex ante standpoint, how effectively might BlackRock, Vanguard, and others exercise the governance tools at their disposal as equity blockholders to manage the risks assumed by their funds? My Article, *The Common Agency Problem in Bank Regulation*, begins to address these questions, focusing in particular on the last: what can asset managers as common agents in corporate governance do and what does this role in governance mean for financial stability?

Ultimately, the aim of this research project lies in addressing the political economy of financial failure to determine whether those shareholders and bondholders who contract to bear the default risk of financial firms, in fact, possess the institutional capacity to do so. As seen in the example of Monti dei Paschi, caution is in order. We have come to rely heavily on investors in capital markets to protect markets against disaster. It is necessary for us to ask whether they can, in fact, provide the much needed buffer to protect the financial system against collapse—or whether these shareholders and bondholders themselves are now too big and too important to fail.

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17. RICKS, *supra* note 14, at 103 (noting the profound damage of banking panics on the broader economy).