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Banks' dividends in Covid-19 times

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Banks' dividends in Covid-19 times[1]

Highlights

- *Regulatory actions in the current circumstances need to focus on preserving banks' lending activity without jeopardising their solvency. This means that flexibility in capital requirements, including through the use of regulatory buffers, and capital conservation should go hand in hand.*
- *Basel III provides for automatic distribution constraints when capital falls below specific thresholds. In the current context, this may disincentivise firms from following authorities' recommendations to use capital buffers.*
- *Blanket distribution restrictions imposed through supervisory action may help address these disincentives to the extent that they are not linked to firms' individual capital positions and thus remove any possible stigma effect.*
- *Most authorities have undertaken initiatives in relation to banks' distribution policies in the Covid-19 pandemic environment. However, practices across jurisdictions diverge markedly as regards scope and stringency.*

1. Introduction

Since the outbreak of the Covid-19 pandemic, authorities worldwide have taken measures to ensure that banks can continue to lend to the real economy. To that end, they have confirmed that firms should use capital buffers to absorb losses, and in addition have granted capital relief in various forms. Many authorities have also restricted distributions of capital, whether through dividends, share buybacks or discretionary bonuses.

Under Basel III, depletion of capital buffers triggers automatic constraints on capital distributions, although jurisdictions have implemented this in different ways. Recent measures taken by authorities also seek to ensure that flexibility in capital requirements and capital conservation go hand in hand. However, as they are based on discretionary supervisory actions, these measures differ across a number of dimensions.

This FSI Brief describes how regulatory distribution constraints operate under Basel III and discusses how that standard has been applied in some jurisdictions. Further, it takes stock of recent supervisory actions aimed at capital conservation and discusses how they differ across a sample of 14 jurisdictions. Lastly, it offers some concluding remarks.

2. Capital buffers and distribution constraints under Basel III

Capital buffer requirements under Basel III

Under Basel III, banks are subject to a total minimum capital requirement of 8% of risk-weighted assets (RWA). This constitutes the Pillar 1 regulatory capital requirement. The minimum Common Equity Tier 1 (CET1) ratio must represent 4.5% of RWA, while the remainder may be met with instruments that have a lower loss absorption capacity (Additional Tier 1 Capital (AT1) and Tier 2 capital (T2)) than CET1.

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Supervisors may set additional capital requirements under the supervisory review process, known as Pillar 2, to reflect firm-specific risks or risks not captured under Pillar 1. Pillar 2 requirements generally need to be met with capital of the same quality as Pillar 1. On top of Pillars 1 and 2, banks are required to hold capital buffers that they can use to absorb losses while continuing normal business.

All these requirements are binding, but they differ in how a breach is sanctioned. The total minimum capital of 8% of RWA is often considered to be a licensing requirement, and its breach may therefore result in the revocation of licence. The consequences of breaching a Pillar 2 requirement are – intentionally – not detailed under the Basel framework, and they vary across jurisdictions.[2] In contrast, the consequences of breaching the buffer requirement are detailed under the Basel Framework: Banks in breach of that requirement are allowed to continue operating, but are expected to rebuild buffers over an appropriate time frame and have to limit capital distributions until those buffers are replenished.

Three different buffers

Basel III provides for three different types of buffer: (i) a capital conservation buffer (CCoB) that applies to all banks at all times; (ii) a system-wide countercyclical capital buffer (CCyB) that applies when and to the extent that it is activated by the relevant national authority; and (iii) a buffer that applies to a bank that is designated as a global or domestic systemically important bank (G-SIB or D-SIB). All buffers must be met with CET1 that is not already used to meet Pillar 1, Pillar 2 or total loss-absorbing capacity (TLAC)[3] requirements.

The calibration method for these buffers differs, reflecting their different objectives. The CCoB, as a permanently fixed requirement, is set at 2.5% of RWA. In contrast, the CCyB rate fluctuates. Its level varies between 0% and 2.5% of RWA, depending on how the relevant authority assesses the system-wide risk at any point in time within the credit cycle. The level of the G-SIB or D-SIB buffer may also vary over time and depends on the systemic importance of the firm within a given financial system. G-SIBs are identified by the FSB on the basis of a methodology developed by the Basel Committee on Banking Supervision (BCBS) and are allocated to buckets that have increasing requirements for loss absorbency. These range between 1% and 3.5% of RWA.[4] D-SIBs are subject to requirements under nationally developed methodologies.

Distribution constraints under Basel III

Under Basel III, distribution constraints do not require supervisory action to take effect when capital buffers are depleted. Rather, they automatically cap what is available for distribution to a maximum amount ("maximum distribution amount" (MDA)).[5] The MDA is the portion of a bank's earnings that may be distributed whenever buffer requirements are not fully satisfied. The remainder must be retained to rebuild buffers. The MDA rate decreases at increments of 20 percentage points with the rate of depletion of total capital. The MDA rate is 100% when a bank meets total capital requirements, including applicable buffers, whereas a bank that has fully used its buffers and has a capital ratio of 8% of RWA is subject to an MDA rate of 0%, ie it cannot make any distributions until it has replenished its buffers.

[2] These include requiring changes to risk management, retention of earnings or limitation on certain investments or activities, and in some jurisdictions also withdrawal of licence. In certain jurisdictions, authorities set additional, informal expectations on capital levels – for example, in the Single Supervisory Mechanism (SSM) countries (Pillar 2 Guidance), in the United Kingdom (Prudential Regulatory Authority (PRA) buffer) or in Australia.

[3] The TLAC standard agreed by the Financial Stability Board (FSB) minimises the risk of a government bailout of large banks. Since 2019, G-SIBs are required to hold a TLAC amount of 16% of RWA, or 6% of the leverage exposure measure, increasing to 18% of RWA, or 6.75% of leverage exposure by 2022. TLAC Instruments need to be able to be written down or converted into equity to recapitalise a firm in resolution. Eligible securities include common equity, subordinated debt and some senior debt.

[4] The highest bucket is by design always empty, to maintain incentives for banks to avoid becoming more systemically important.

[5] Basel III (Risk-based Capital Requirement 30.4) refers to "minimum capital conservation standards" rather than an MDA. For ease of reading, this Brief uses the equivalent concept of MDA, which is used by most jurisdictions discussed herein. For example, if earnings are 100 and the capital conservation standard is 40%, then the MDA is 60 [(100 – (0.4 x 100)].

Specifically, these distribution constraints operate as follows.

- At each distribution date, the MDA is recalculated, and the resulting constraint applies to distributions intended to be made after that date. As a result, a permitted distribution may result in a lower capital ratio than the one that was the basis for calculating the applicable MDA.
- Distributions subject to constraints include dividends, share buybacks, payments on other T1 instruments and bonuses to staff, but exclude (i) any dividends that have been declared in line with the applicable MDA and (ii) any non-discretionary payments that legally cannot be cancelled without constituting an event of default.
- Supervisors may impose additional restrictions – for example, time limits on rebuilding buffers or restrictions at solo level to conserve capital in specific parts of a group. However, distribution constraints do not apply to the extent that a bank raises capital at the same time.

3. Implementation of Basel III distribution constraints

While all BCBS member jurisdictions comply with the Basel III buffer standard, implementation by jurisdictions differs in a number of respects. Table 1 takes a closer look at how the Basel III capital conservation standard has been implemented in the United States, the European Union and China.

Implementation of the Basel III CCoB standard in US, EU and China — Table 1

Dimension	US	EU*	China
Reference date	End of last quarter	Date of payment	Date of payment
Restrictions apply by virtue of…	statutory provisions	statutory provisions	supervisory action
If buffer threshold is met…	no constraints apply	no constraints apply, provided threshold met after payments	no constraints apply, provided threshold met after payments
If buffer threshold is not met…	constraints apply w/r to CET1, AT1, T2 and bonuses	constraints apply w/r to CET1, AT1 and bonuses	constraints apply as per supervisory discretion
- MDA** calculated on the basis of	net income of last 4 quarters, net of distributions (***)	interim profits since last profit appropriation	net income of last 4 quarters
- multiplied by…	0% to 100%, in quarterly increments	0% to 100%, in quarterly increments	as per supervisory discretion
- MDA can be increased…	with supervisory approval	with supervisory approval	as per supervisory discretion
- MDA can be decreased…	subject to general provisions	subject to general provisions	subject to general provisions
Supervisory approval required	Yes, under CCAR (****)	No	No

"Buffer threshold" refers to applicable buffers collectively, in addition to minimum capital requirements. "Payment" denotes any payment to holders of capital instruments (redemptions, repurchases, coupons or dividends) or discretionary variable remuneration to staff.

* Including the UK, as the relevant EU legislation substantially continues to apply post-Brexit.

** MDA: maximum distribution amount, or maximum portion of earnings that may be distributed if capital is below the buffer threshold.

*** However, with effect from March 2020, the US calculates the MDA on the basis of the greater of (i) a bank's tax-adjusted net income for the four preceding quarters, net of any distributions; and (ii) the average of a bank's net income over the preceding four quarters.

**** Starting in Q4 2020, the restrictions imposed by the Comprehensive Capital Analysis and Review (CCAR) will be replaced by the stress capital buffer, which will restrict capital distributions under the capital rule.

Sources: US Capital Rule, 12 US Code; EU Capital Requirements Regulation (CRR); China Capital Rules.

Table 1 reflects some differences that are particularly significant in the current context. These relate to the following aspects:

- Severity, ie whether a distribution may or may not result in a temporary depletion of a buffer. For example, in the EU, but not in the US, a payment in respect of a CET1 instrument must not result in CET1 falling below the total requirement, including applicable buffers.
- Scope, ie whether distribution constraints differentiate between capital components – for example, whether they include remuneration of T2 instruments. In the current context, distribution constraints could disrupt markets for AT1 and T2 instruments to a disproportionately higher degree than those for equity instruments. This is because retained earnings may raise the accounting value of shares, which mitigates the impact of dividend restrictions on stock market values.[6] In the case of AT1 or T2 instruments, however, non-paid coupons are non-cumulative and therefore cannot increase the instrument's accounting value.
- Process, ie whether and to what extent distribution constraints apply automatically or rather as a result of supervisory action. This could also be relevant in the current context. Authorities worldwide are seeking to ensure that banks continue to lend and refrain from excessive deleveraging. They have therefore encouraged banks to use their buffers to absorb losses. However, banks could have incentives not to follow those recommendations to the extent that they would trigger distribution constraints. As a result, the overall objective of maintaining lending and preventing excessive deleveraging may be frustrated.[7]

This may partly explain why, in the United States, the encouragement to banks to use buffers has been combined with a regulatory change to make the automatic distribution constraint more gradual for certain banks. Until recently, the MDA in the US was calculated on the basis of the income of the last four calendar quarters, net of distributions. For banks that have distributed most of their earnings, such a rule could have abruptly reduced future distributions even if capital ratios had only marginally fallen below the applicable buffer requirements. That effect could, in turn, have caused banks to limit lending in the current crisis in order to avoid such constraints and their likely impact on share prices.

This possible outcome has led US agencies to change the rule so that it provides for two alternative methods of calculating the MDA. Under one method, the MDA is, as before, calculated on the basis of banks' tax-adjusted income for the four preceding quarters, net of distributions. Under the newly introduced alternative method, the MDA is calculated on the basis of banks' average quarterly income over the preceding year, gross of distributions. Banks shall calculate their MDA on the basis of the method that results in the greater amount.

For banks with high distribution ratios over the previous quarters, the newly introduced alternative method results in more income being available for distribution. As a result, distribution constraints for such banks when buffers are used set in more gradually than they would under the former calculation method and payment reductions would be less pronounced.[8]

4. Supervisory distribution restrictions in light of Covid-19

The current crisis presents authorities with two challenges: they need to ensure that firms have sufficient resources to support the real economy, and they need to ensure that these resources are put to that use.[9] To achieve the first objective, authorities have recommended that firms use their capital buffers, and have

[6] The moderating effect would normally be larger the larger the ratio of banks' market-to-book ratios.

[7] For a broader discussion of buffers and prudential policy, see Drehmann et al (2020).

[8] During these times, banks are expected to continue to manage their capital actions prudently.

[9] For this and regulatory crisis response measures more generally, see Borio and Restoy (2020).

relaxed capital requirements in various ways, including by reducing CCyB rates to zero, reducing RWA or adjusting leverage ratio calculations.

Yet capital relief alone does not ensure that all available resources will be deployed as intended by supervisors. To achieve this second objective, a number of supervisory authorities have imposed restrictions on capital distributions. Those restrictions are a natural complement to the relaxation of capital requirements, as they induce banks to devote as much resources as possible to absorbing losses and maintaining lending levels. Moreover, by suspending or severely limiting all distributions, the restrictions may contribute to a more socially acceptable sharing of the overall costs of the pandemic (Carstens (2020)).[10] At the same time, supervisors need to weigh the potential market impact of any action taken that could affect the remuneration of capital instruments.

Table 2 takes stock of supervisory conservation measures taken in a sample of 14 jurisdictions. Importantly, these measures go beyond the constraints that bind individual banks if buffers are used, because they apply by design to all banks in a jurisdiction, irrespective of their capital ratios. Essentially, they are non-discriminatory, blanket measures that seek to avoid stigmatising any individual firm as being too weak to pay dividends. Note, however, that the national frameworks and corporate practices under which authorities have taken their measures may themselves differ, and this may have a bearing on how the measures compare. The more relevant aspects include the following:

First, national frameworks differ in how they constrain banks' distribution decisions. Thus, some jurisdictions mandate that a minimum portion of profit be paid out as dividends to shareholders, while others do not or require that a portion of profit must be retained. Some authorities may not have the powers to supersede minimum dividend requirements, while those in jurisdictions with high minimum retention rates have comparatively less need for supervisory action.

Second, the frequency of distributions differs from country to country. In some jurisdictions, banks may distribute profits twice a year or more frequently. In such cases, 2019 profits have mostly been distributed, and supervisory actions will therefore affect only distributions related to 2020 profits. Conversely, where distributions are made yearly for the preceding year, supervisory measures will affect payments for 2019 and maybe also those for 2020.[11]

Third, national frameworks differ in the degree to which they restrict or disincentivise share buybacks. In some jurisdictions, share buybacks are in principle banned subject to more or less narrow exemptions.[12] Moreover, tax regimes may differentiate between economically similar types of distribution – for example, through preferential status for share buybacks – and this may have a bearing on distribution policies.[13] Consequently, the need, and scope, for authorities to restrict share buybacks differs across countries.

[10] On this, see also Drehmann et al (2020).

[11] In Australia, Brazil, Canada, South Africa, the United Kingdom and the United States distributions are made several times a year, whereas in China, India, Japan, Russia, Sweden, Switzerland and most SSM countries distributions are made annually.

[12] Bans with narrow exemptions exist in France, Germany, Sweden and Switzerland. In the European Union, shares can generally only be bought back by using funds that could be distributed as dividends. In the United States, large banks pay out between two thirds and four fifths of their shareholder distributions in share buybacks.

[13] Generally, share buybacks are paid out of income before tax, while dividends are paid out of income after tax.

Publicly announced supervisory initiatives

Table 2

Jurisdiction	Guidance on capital distributions (dividends and share buybacks)*	Guidance on bonuses*	Source
Australia	All distributions to be suspended until June 2020 or, subject to stress tests, materially reduced	Executive bonuses to be appropriately limited	APRA capital management letter, 7 April 2020
Brazil**	All distributions to be suspended until 30 September 2020 Buybacks to be limited to 5% of stock	Executive bonuses not to be increased	BCB Resolution no 4797, 6 April 2020
Canada	Dividends not to be increased Buybacks to be suspended	Executive and staff bonuses not to be increased	OSFI Press Release, 13 March 2020
China	No additional restrictions	No additional restrictions	n/a
India	Dividends to be suspended until 30 September 2020 No additional restrictions on buybacks	No additional restrictions	RBI Notification, 17 April 2020
Japan	No additional restrictions	No additional restrictions	n/a
Russia***	Dividends to be suspended until 30 September 2020 No additional restrictions on buybacks	Executive bonuses to be partly deferred	CBR Press Release, 9 April 2020
Singapore	No additional restrictions on dividends Buybacks not to be funded by released buffers	No additional restrictions	MAS Media Release, 7 April 2020
South Africa	No dividends to be paid in 2020 No additional restrictions on buybacks	Executive and staff bonuses not to be paid in 2020	SARB Guidance Note 4/2020, 6 April 2020
SSM	Dividends to be suspended until 1 October 2020 Buybacks aimed at remunerating shareholders to be refrained from	No additional restrictions	ECB Recommendation, 27 March 2020
Sweden	No dividends to be paid in 2020 No additional restrictions on buybacks	No additional restrictions	FI Press Release, 26 March 2020
Switzerland	Dividends paid after 25 March 2020 to be deducted from capital relief No additional restrictions on buybacks	No additional restrictions	FINMA Guidance 2/2020, 31 March 2020
United Kingdom	Outstanding 2019 dividends cancelled No distributions to be made in 2020	Executive and staff bonuses not to be paid in 2020	PRA Letter to major UK banks, 31 March 2020
United States****	No additional restrictions	No additional restrictions	Fed Press Release, 1 April 2020

* Beyond restrictions already imposed by supervision and regulation.

** Mandatory minimum dividend applies; distributions include dividends, buybacks and interest on equity ("juros sobre capital proprio").

*** Statutory provisions restricting buybacks have been eased to allow banks to address Covid-19-related corrections in share prices.

**** In the United States, the eight largest banks have voluntarily agreed to postpone all share buybacks until the end of June 2020.

Table 2 also shows that, notwithstanding a certain trend towards tighter capital conservation, authorities' public measures differ across a number of dimensions. These include the following aspects:

First, measures differ in their scope. Some jurisdictions have undertaken initiatives that capture all types of distribution, including dividends, share buybacks and bonuses. Others apply different regimes to dividends and share buybacks. Most jurisdictions have not restricted bonuses.

Second, the degree to which authorities restrict distributions differs. In some jurisdictions no distributions at all will be paid in 2020, while in others authorities have issued high-level recommendations not to increase distributions.

Third, authorities' measures differ in terms of the period of time for which they will apply. Some authorities have specified a fixed period, even if only tentatively, while others have taken more open-ended measures that apply until they are alleviated or removed. Moreover, the fixed periods of application differ in length, with the minimum extending until mid-2020. The United Kingdom is the only jurisdiction in which restrictions apply retroactively by cancelling outstanding 2019 dividends, albeit with regard to only the seven largest systemically important UK banks.[14]

Fourth, given the extreme market sensitivity, some authorities may have preferred to make specific and targeted recommendations to the institutions as part of their regular supervisory dialogue rather than to publicly issue general restrictions.

Concluding remarks

Many authorities have restricted capital distribution by banks in their jurisdictions. This reflects a broad consensus that capital conservation – beyond that envisaged in Basel III – is a necessary complement to the effective relaxation of capital requirements which is now being applied worldwide with the objective of preserving banks' lending activity. However, not all important financial centres have issued concrete public guidance on the matter. Moreover, among those that have taken public action, the scope, severity and duration of the measures differ, so that conservation measures are not fully comparable across countries.

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