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Covid-19 bank dividend payout
restrictions: effects and trade-offs

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Covid-19 bank dividend payout restrictions: effects and trade-offs

Key takeaways

- *In the context of the Covid crisis, authorities adopted dividend payout restrictions to enhance bank resilience and support stronger growth in bank lending. Restrictions may reduce short-term equity returns for bank shareholders, especially in the case of banks with a low price-to-book ratio.*
- *In line with these predictions, bank equity prices fell with dividend restriction announcements, but credit default swap (CDS) spreads indicated that default risk either fell or was unaffected, even in the face of the economic downturn.*
- *Bank capitalisation rose in jurisdictions which restricted payouts, supporting institutional and system-wide stability; the increased capital was more likely to support greater lending with restrictions present.*

Covid-19 presents an ongoing challenge for supervisors and other policymakers charged with ensuring financial stability while maintaining the flow of credit to the economy. To address these goals, regulators adopted a number of policy measures, including restrictions on bank capital payouts such as dividends. Payout restrictions were intended to preserve bank capital in case large losses arose and channel bank resources towards lending. This Bulletin examines how these restrictions affected banks' payouts, capitalisation and lending, and their effect on banks' equity prices and credit default swap (CDS) spreads.

Capital payouts by banks can set at odds the interests of different bank stakeholders, such as shareholders and creditors. Bank valuations fell in March 2020 during the initial pandemic turmoil, driving incentives to pay dividends to boost short-term shareholder returns (Gambacorta et al (2020)).¹ However, such payouts erode the existing book capital base and increase riskiness, contrary to the interests of debt investors and depositors. They also reduce the capital available to support lending, with negative implications for borrowers and the broader economy.²

For these reasons, dividend restrictions did not receive unqualified support from all stakeholders. And a number of additional considerations qualify the crisis-time trade-offs outlined above (ESRB (2020)). Retaining more capital can lower borrowing costs for banks, but it could also discourage future efforts to raise equity. A sector-wide ban on payouts can remove the stigma for those individual banks that restrict dividends, but it punishes prudent banks with sizeable capital buffers that could safely pay out their profits.

This note sheds light on these arguments in the Covid-19 context, examining the evolution of banks' equity and CDS prices, and their capitalisation and lending around the implementation of payout

¹ Bank capital payouts may have externalities that lead to excessive dividends and inefficient recapitalisation. See Acharya et al (2016). See Allen and Michaely (2003) and Aramonte (2020) for further discussion about why firms pay out capital.

² Indeed, during the 2008 financial crisis, banks continued to pay out dividends despite rising credit losses, which may have contributed to their reluctance to lend (Acharya et al (2011)). Payout restrictions are seen as an essential complement to measures encouraging the use of capital buffers, to ensure that any resources freed up by those and other measures are not paid out to shareholders but are instead provided as credit to the economy. Buffer usage normally triggers a restriction in dividends, so restricting all dividends also removes the penalty from using those buffers (Svoronos and Vrbaski (2020)).

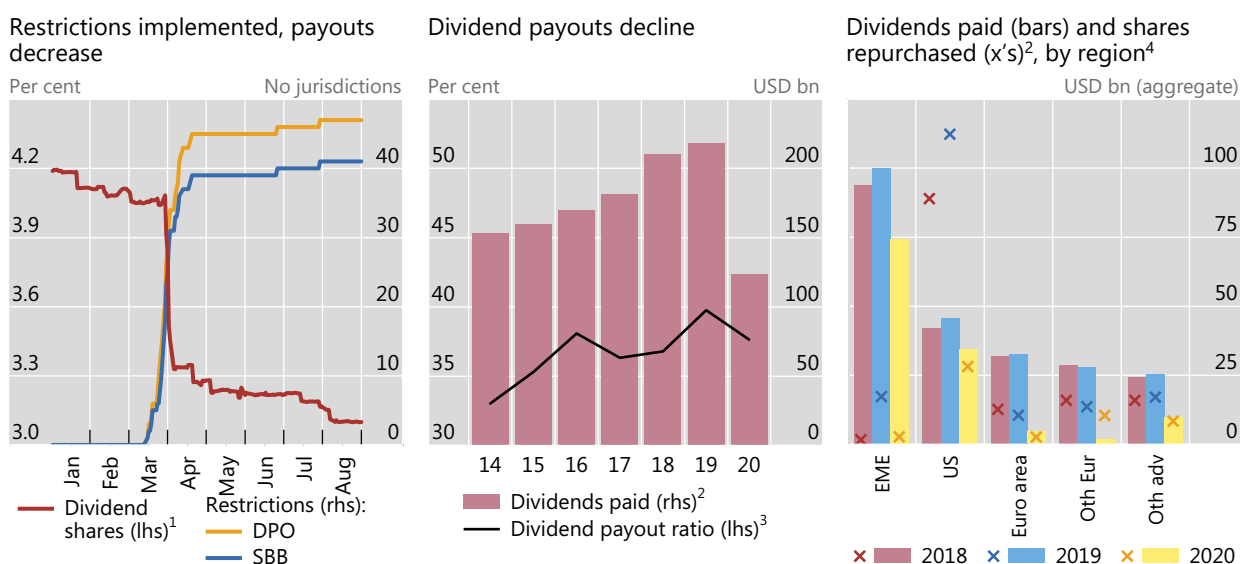
restrictions. Equity prices fell in tandem with the anticipated reduction in dividends, but CDS spreads did not rise. Capitalisation rose with restrictions, and such restrictions helped banks better leverage additional capital into more lending.

Restrictions on payouts in response to the pandemic shock

With the widespread impact of Covid-19 in March 2020, supervisors in some jurisdictions began imposing restrictions on banks' capital distributions, such as through dividends, share repurchases and bonuses (ESRB (2020); Svoronos and Vrbaski (2020)). By the end of April, 45 jurisdictions had implemented dividend restrictions, while 39 restricted share buybacks, with differing degrees of intensity (Graph 1, left-hand panel).³ As these restrictions were announced and implemented, analysts' forecasts of 12-month-ahead dividends of large banks fell. This decline appears to have been driven by the restrictions themselves: dividends anticipated by market analysts did not change with the market stress in March, but they dropped sharply once the restrictions were announced at the end of March.

Restrictions announced, distributions fall

Graph 1



¹ Simple average across a sample of 103 banks. Dividends are anticipated annual dividends per share as of the given date. Dividend shares are calculated as a percentage of the January average of the stock price in local currency for each bank. ² Based on a sample of 84 banks in 23 countries for which complete data are available over the period 2014–20. For 2020, as-of date varies per bank and includes data reported by Jan 2021. ³ Dividends paid as a percentage of net income; weighted average by net income. ⁴ Bars indicating dividends paid, and x's, indicating shares repurchased, are aggregated across all banks in the respective region. The following jurisdictions' banks are included in each region: Euro area: BE, DE, ES, FI, FR, IT and NL; Oth Eur: CH, DK, GB, NO and SE; Oth adv: CA and JP; EME: BR, CN, ID, KR, MX, RU and SA.

Sources: Datastream; FitchConnect; SNL Financial; BIS calculations.

Restrictions on capital distributions had a large effect on the actual amount of dividends paid. The aggregate dividends paid during 2020 were as much as 57% lower than their 2019 value (Graph 1, centre panel).⁴ The decline was concentrated in Europe (right-hand panel). Dividends for large banks there declined to nearly zero in 2020, with just a few banks paying out some dividends before restrictions were implemented. Dividends for emerging market banks, including those in China, fell by a more modest 26%. US banks paid out capital mainly via share buybacks, which declined dramatically in 2020 to just 25% of their 2019 value.

³ Not all of these restrictions were fully binding on all payouts, some provided only partial or less stringent restrictions.

⁴ Due to reporting lags, not all dividend data are available for Q4 2020, but since these restrictions generally extended through the end of 2020, the remaining dividends to be reported should not significantly change the picture.

Equity price and CDS spread reactions

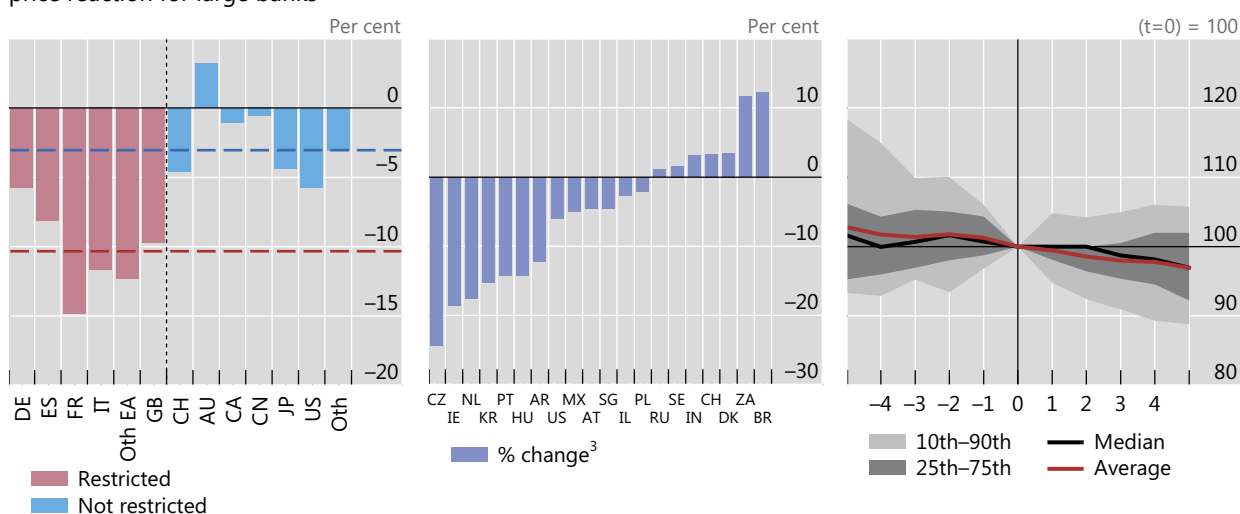
Stock prices for large banks in the euro area and the United Kingdom declined by 10% on average around the time of the restriction announcements by the ECB and the Bank of England in late March, (Graph 2, left-hand panel, dashed red line). Large banks in other jurisdictions which had not (yet) imposed restrictions, but that were potentially subject to the same global market forces, saw declines of just 3% on average over the same time frame (dashed blue line). For this reason, the additional decline in bank share prices may have been attributable to the dividend restrictions themselves.

Bank share prices fell after payout restrictions announced

Graph 2

ECB/BoE announcements and stock price reaction for large banks¹

Bank stock index reaction around announcement events²



¹ Sample of 105 large banks. Percentage change from end-day 26 Mar to end-day 31 Mar (three full trading days), simple average. Jurisdictions to the left of the dotted line had effective restrictions announced within those dates (ECB on 27 Mar, BoE on 30 Mar). Horizontal dashed lines indicate the group average for jurisdictions on the left (red) and right (blue). ² $t=0$ is one day before restrictions are announced by regulators in each jurisdiction. Stock price indices are normalised to 100 at $t=0$. Index covers equity prices of all banks in the jurisdiction. Sample includes: AR, AT, BG, BR, CH, CY, CZ, DE, DK, EE, ES, FI, FR, GR, HR, HU, IE, IL, IN, IT, KR, LT, MT, MX, NL, NO, PL, PT, RO, RU, SE, SG, SI, UK and US. Percentiles and averages calculated at each date. ³ Five-day post-announcement average of stock returns minus the corresponding pre-announcement average.

Sources: Datastream; BIS calculations.

Across countries, the announcements of dividend restrictions came at different times, but were generally followed by a drop in bank equity prices (Graph 2, centre panel). While negative reactions were not universal, banks in a broad set of 36 countries with restrictions saw declines in the days following the announcement (right-hand panel). On average, equity prices fell 3% over the following five days.

Beyond the general announcement effect, investors responded to changes in the anticipated dividend payouts by individual banks (12-month-ahead analyst forecast). The impact was greatest for a few large European banks from Germany, France, Italy, the Netherlands and the United Kingdom (Graph 3, left-hand panel). Their stock prices reacted more strongly the larger the decline in expected dividend payouts (centre panel).⁵ A 10% lower expected payout per share (relative to the share price) from one day before to four days after the announcement date is matched by an extra 4% decline in the stock price over the same span.

In contrast to its impact on the share price, the decline in anticipated dividends boosted the perceived safety of the banks. A larger decline relative to capital correlated with a smaller increase in CDS spreads.

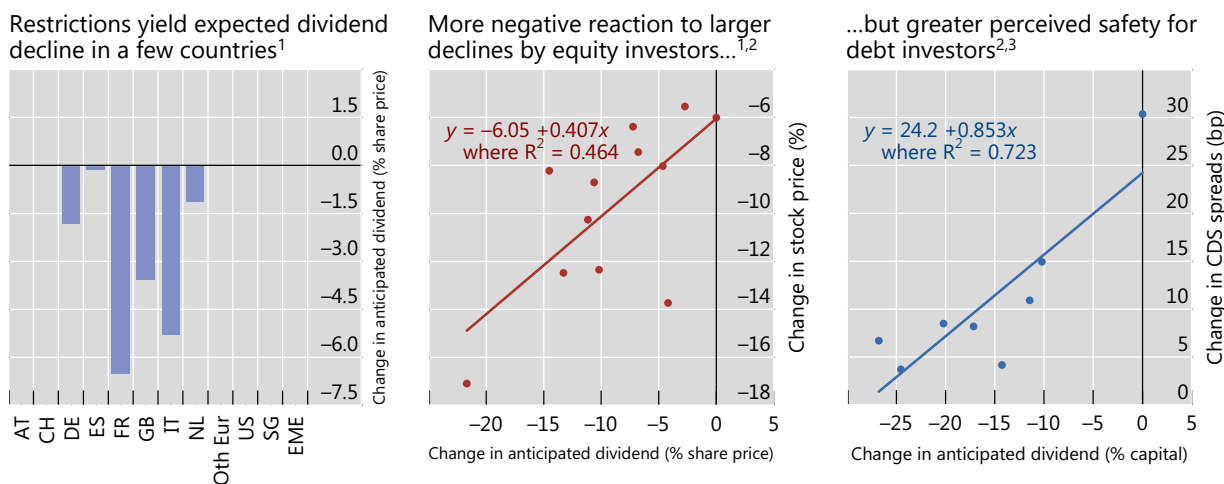
⁵ Including other banks with little or no expected change in anticipated dividends adds a lot of noise around the y-axis line.

In other words, retaining more profits seemed to reassure debt investors, underlining the divergent interests of creditors and equity holders.⁶

Anticipated declines in dividends for large banks after announcements

12-month anticipated dividend per share, change from $t-1$ to $t+4$ around restriction announcement

Graph 3



¹ Difference in anticipated annual dividends per share between dates $t-1$ and $t+4$ business days, as a percentage of the Jan 2020 average of the bank's stock price. Date t is the date of the restriction announcement for each bank. Each date is common for all banks in a given country. ² Change in stock and CDS prices is over the same interval, subtracting the average stock or CDS price change, and for stocks normalising by the $t-1$ price. Only banks in DE, FR, GB, IT and NL are included in the scatter plots. ³ Anticipated dividend change is computed as the change in anticipated dividends per share between $t-1$ and $t+4$ business days around the date of the restriction announcement, multiplied by the number of common equity shares outstanding and expressed as a percentage of Q4 2019 Tier 1 capital. A couple of large outliers in this variable are excluded, but their inclusion does not change the relationship with CDS change.

Sources: Datastream; SNL Financial; BIS calculations.

In the US, payout restrictions were announced in connection with the June 2020 stress test results. The restrictions barred share buybacks for all banks, which account for 70% of their capital payouts, and capped dividends conditional on sufficient profits.⁷ Bank stock prices fell with the announcement and remained depressed relative to other banks' developments (Graph 4, left-hand panel).

Comparing US banks by their stress test results reveals that the poorest performers saw larger stock price declines in the five days after the release, particularly those below the common equity tier 1 (CET1) ratio of 13% (Graph 4, centre panel).⁸ Banks are typically barred from payouts when they fail a stress test until their buffers are sufficient. While no banks failed the stress test, the Federal Reserve stated that it might impose further restrictions on banks and asked them to re-evaluate and resubmit distribution plans.

In contrast to stock prices, changes in CDS spreads were uncorrelated with the stress test results (Graph 4, right-hand panel). CDS spread movements here and above do not indicate that the restrictions or resulting decline in market values undermined bank solvency or incited a run by creditors. If anything, they suggest that default risk was either reduced or unaffected. Bank funding costs spiked during the initial market turmoil in March, but generally declined from 23 March onward, even as profits continued

⁶ Several large outliers are dropped from the right-hand panel. Their inclusion does not change the general relationship. The sample in the centre and right-hand panels is small, but suggestive that the price changes observed for these banks were indeed related to the restrictions imposed on their dividends.

⁷ The FRB also introduced the stress capital buffer (SCB), which adds a bank specific capital buffer to the existing countercyclical capital buffer, to be met by 1 October 2020. Goldman Sachs was the only bank to not already satisfy their total capital buffer requirement with this addition, but they announced at the time that they intended to proceed with dividends nonetheless. Wells Fargo was the only bank to be restricted from dividends based on insufficient past profits.

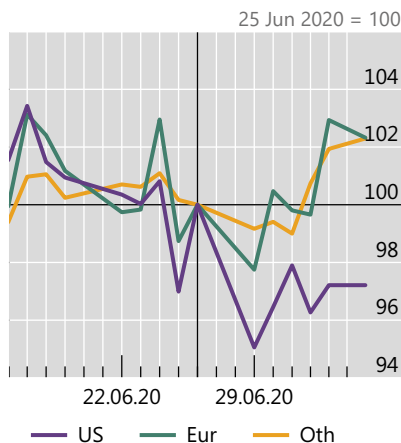
⁸ The stress test results were released at 4:30pm on 25 June, after the trading hours for the NYSE and NASDAQ have closed, so prices at close on 25 June are used as the pre-announcement prices. The Federal Reserve announced on 4 September 2020 that they made small mistakes affecting the calculation of the capital requirements for Goldman Sachs and Morgan Stanley. I use the results as originally released on 25 June since those are the ones which investors reacted to after the announcement.

to be retained and valuations remained depressed (Aldasoro, Fender, Hardy and Tarashev (2020)). Thus, the stronger fall in stock prices for poorer stress test performance was probably driven by expectations about further payout restrictions for those banks, rather than revealed information about their riskiness.

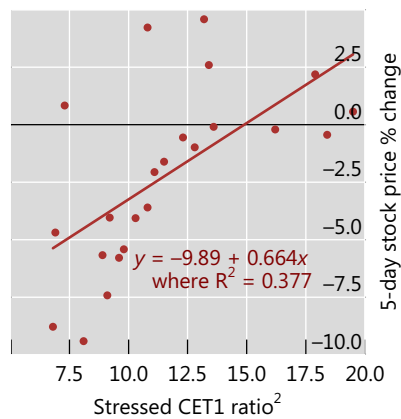
Investor reactions to US stress test results and payout restrictions

Graph 4

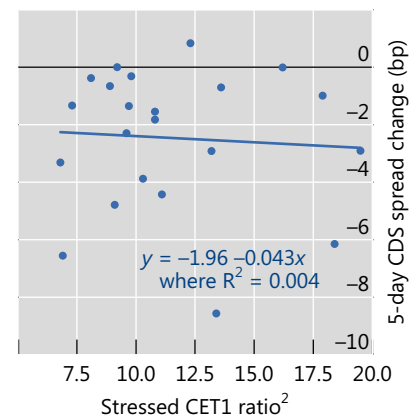
Stock price for US banks falls relative to others after results published¹



Investors punished low performers³



CDS spreads showed no change in perceived default risk⁴



¹ Stock prices normalised to 100 on 25 Jun 2020, average across 105 large banks in the US, Europe (AT, BE, CH, DE, DK, ES, FI, FR, GB, IT, NL and SE) and other countries (AR, AU, BR, CA, CN, ID, IN, JP, MX, NO, RU, SA, SG, TR and ZA). ² Stressed CET1 in the severely adverse scenario (data as of CCAR release date). ³ Includes 24 of the 33 stress-tested banks. Parent data used for BNP USA, RBC US and Santander USA. ⁴ Includes 22 of the 33 stress-tested banks. Parent data used for BNP USA, MUFG America, RBC US and Santander USA.

Sources: Dodd-Frank Act Stress Test 2020; Bloomberg; Datastream; Markit; BIS calculations.

Maintaining capital and supporting lending

The policy imperative in favour of restrictions rests on two issues: the stability of the banking system and supporting credit to the real economy. These outcomes should be set against the declining bank share prices when evaluating the value of implementing dividend restrictions in the early stages of the crisis.

Restrictions were intended to help preserve bank capital in case large losses started to accrue. Capitalisation fell in Q1 2020 as the Covid crisis hit unexpectedly. However, in countries which implemented restrictions, capitalisation rates recovered and even went up (Graph 5, left-hand panel). This increase in capital came despite falling profits. Capital ratios continued to fall in countries which did not implement restrictions. Thus the impacts of payout restrictions have not yet validated the view that they would hinder the raising of new capital to a greater degree than the capital they save.

Payout restrictions were also intended to bolster bank lending. The retained earnings can be channelled into new lending, but quantitatively more significant, the higher capital cushion lowers funding costs and can be leveraged to support increased lending (Gambacorta and Shin (2018)). Aggregate loan growth increased in countries without restrictions but fell in countries with them, reflecting trends in profitability and other underlying differences. Examining the changes in capitalisation from Q4 2019 to Q2 2020 relative to the risk-weighted assets at end-2019 helps to connect the capital saved from restrictions to the change in lending. This captures how much lending capacity increased for the bank with the capital built up during the first half of 2020. Banks that increased their lending capacity more also increased their loan growth more (Graph 5, right-hand panel). Strikingly, this relationship is much stronger (and statistically significant) for banks in countries that implemented payout restrictions.

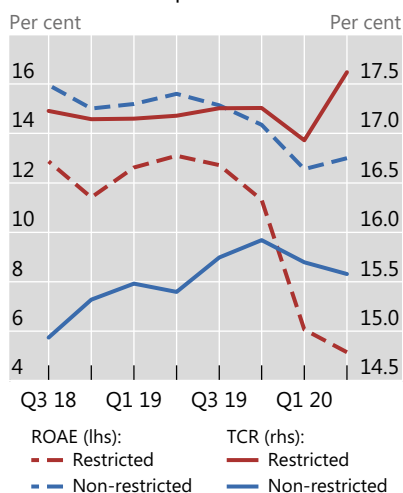
Payout restrictions appear to be effective at both increasing the capital available to the bank and channelling the additional resources towards lending. An increase in capital of 2% of risk-weighted assets resulted in loan growth that was 6.7 percentage points higher. These findings corroborate the hypothetical

exercise in Gambacorta et al (2020), which finds that a complete ban on dividends would have boosted lending capacity by 2–16%, by showing that the predicted capacity boost was actually deployed into lending. Thus, these restrictions in the initial phase of the Covid crisis supported policymakers’ objectives.

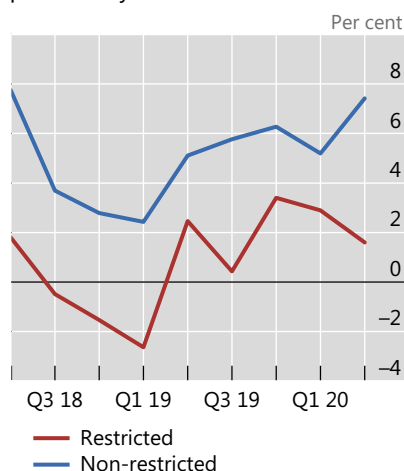
Bank capitalisation and lending¹

Graph 5

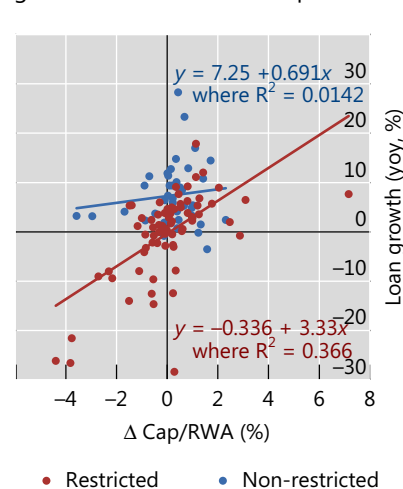
Capitalisation² rose in restriction countries while profits³ fell



Aggregate loan growth followed profitability⁴



Capitalisation increase boosted loan growth with restrictions in place⁵



¹ Sample of 133 large banks. A linear interpolation is done for banks that do not report quarterly statements so that a constant sample is used. “Restricted” includes banks in countries where a policy change announcement was made on or before 30 Jun 2020: AR, AT, BE, BR, CH, DE, DK, ES, FI, FR, GB, IN, IT, KR, MX, NL, NO, RU, SE, US, ZA. Patterns are robust to excluding the US. “Non-restricted” banks are those in AU, CA, CN, ID, JP, SA, SG, TR. ² Only banks for which total regulatory capital ratio (TCR) is available at all points over the last eight quarters are included. ³ Only banks for which return on average equity (ROAE) data are available at all points over the last eight quarters are included. ⁴ Annual growth in gross loans. Only banks for which loan data are available at all points over the last eight quarters are included. ⁵ X-axis is the change in capital levels between Q2 2020 and Q4 2019, as a percentage of Q4 2019 risk-weighted assets. Y-axis is year-on-year loan growth as of Q2 2020, excluding one outlier.

Sources: FitchConnect; BIS calculations.

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