A Few Observations on Bank Dividends

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On June 16, the Federal Deposit Insurance Corporation (FDIC) released the “Quarterly Banking Profile” which gives an overview of the performance of FDIC-insured commercial banks and savings institutions over the first quarter. The FDIC reported that U.S. banks paid nearly twice as much in dividends as they earned in the first quarter, and this datum has provoked concern at the FDIC and elsewhere that banks were depleting capital that they might need in an uncertain future. A more nuanced look at that the issue shows there is far less room for concern than initially meets the eye.

BACKGROUND

Banking organizations (bank holding companies and independent banks) distribute capital to their shareholders via dividends (common plus preferred) and share repurchases.¹ Both forms of payouts reduce capital and banks' balance sheets; however, there are important differences between the two. Changes in a banking organizations' dividend policy are seen as providing a signal about its future performance, therefore when a banking organization announces a reduction of its dividend the stock price of the bank often falls. By contrast, banking organizations adjust the size of share repurchase programs much more frequently and often do not make an announcement every time they buy back shares. The regulations developed since the last crisis limit the share of dividends in total payouts in order to increase the ability of banks to conserve capital when economic conditions deteriorate. For instance, in 2019 banking organizations paid $85bn in common and preferred stock dividends and repurchased about $147bn in common stock. Aggregate net income last year was $241bn, thus banking organizations paid about 35% of their net income in dividends and close to 61% in share buybacks.²

DISCUSSION

The FDIC reported that the country’s 5,100 banks declared dividends of $32.7bn for 1Q20, compared to $18.5bn in net income. A few important caveats are in order. First, most of these dividends were payments by subsidiary banks to their holding companies and not dividend payments by independent banks to their shareholders. Second, a large share of the subsidiary bank to holding company dividend was used to fund share repurchases that were already suspended by many banks. Third, the rise in the payout ratio of banking organizations in the first quarter was in large part driven by the decline of banks' income due to the implementation of the new current expected credit loss (CECL) accounting standard combined with the sharp deterioration of the economic outlook. Fourth, the bank dividends were all in compliance with regulations that limit the ability of a bank to up-stream the dividend to the parent holding company.

First, almost all of the dividend payments quoted in the FDIC report are dividend payments by subsidiary banks to their holding companies. Specifically, banks that are a subsidiary of a holding company paid more

¹ The sample includes the top consolidated entity of bank holding companies, commercial banks, saving and loan holding companies, and savings banks.
² For the 34 banks subject to the Federal Reserve's stress tests, share buybacks represent nearly 70% of distributions those banks made in 2019.
than $29bn in dividends to the parent. Those dividends were used to cover dividends on common and preferred stock by the bank holding company, share repurchases, payments on long-term debt and to reallocate capital across the various subsidiaries of the holding company. Some of these uses tend to benefit the subsidiary banks directly and indirectly, as the holding company is legally obligated to serve as a source of strength to its subsidiary banks, and also, for the largest firms, to incur the losses of the bank in resolution through bail-in of holding company debt holders.

Second, as the coronavirus crisis unfolded in March, the global systemically important banks (GSIBs) announced a suspension of share repurchases on March 15 that would be in place until the end of the second quarter. Several other large bank holding companies made similar commitments to suspend their share repurchases. As shown in Exhibit 1, banking organizations’ dividends on common and preferred stock were about $22.9bn in the first quarter and accounted for approximately 99% of net income (net income across all banking organizations was $23bn). In addition, banking organizations repurchased $38bn in common stock and the overall payout ratio (dividends on common and preferred stock plus repurchases) was nearly 265%. In the second quarter, banking organizations will likely pay the same dividend of nearly $23bn and continue to refrain from the $38bn in repurchases to preserve capital.

Third, the rise in the payout ratio of banking organizations in the first quarter was in large part driven by the decline of banks’ income due to the implementation of the CECL accounting standard combined with the deterioration in the economic outlook. Under CECL, banks are required to establish a credit loss allowance based on the expected lifetime losses of all loans. Establishment of that allowance (a banking name for what other companies call a reserve) is an expense that reduces earnings, and therefore increases the ratio of dividends to earnings. In other words, some of the increase in the ratio of dividends to earnings is attributable to banks establishing a reserve against future losses, not returning its earnings to shareholders.
The calculation of the allowance under CECL depends importantly on forecasts of the business cycle over a medium-run horizon, therefore the sharp deterioration in credit conditions in March led to a large increase in the allowance. Using the regulatory proxy of the allowance for credit losses under the incurred methodology for banks that adopted CECL in the first quarter, earnings would have been nearly $37bn higher in the first quarter. As shown in Exhibit 1, the share of dividends to income would have been 38% rather than 99%, and the overall payout ratio would have been 101% rather than 263%. The “CECL-adjusted” payout ratios are very similar to the ones observed at the end of last year. In short, banking organizations’ payout ratios rose in the first quarter because banks had to set aside reserves to meet future expected losses, not because of losses that were “incurred” in that quarter.

Fourth, the bank dividends were all in compliance with regulations that limit the ability of a bank to up-stream the dividend to the parent holding company. Those regulations are sound and incorporate the realities above. Generally, banks cannot pay a dividend to the holding company that exceeds the sum of net income over that year and retained income over the preceding two years. Thus, as the net income of a bank declines, the capacity of the bank to up-stream the dividend to the parent is also reduced. There hasn’t yet been a decline in the dividend from the bank to the parent because the coronavirus shock unfolded at the end of the first quarter, but if diminishing profitability continues most banks will not be able to sustain the current dividend to their parent.

Lastly, it may be worth noting that recent reports indicate that bank revenues will be strong in the second quarter based on better-than-expected trading income and underwriting activity at the largest banks. As a result, the ratio of dividends to net income will most likely be lower this quarter. Moreover, if the economy evolves in line with baseline projections several banks will no longer need to increase significantly their reserves in the coming quarters because under CECL banks are required to frontload the build in their allowances. We could even see zero or negative provisions in the third quarter if expectations about the economic outlook improve substantially.

**CONCLUSION**

A superficial look at the FDIC’s recent release would suggest that banks paid out 177 percent of their first-quarter earnings in dividends to shareholders. A deeper analysis suggests that banks paid considerably less dividends to its shareholders even taking into consideration the adoption of CECL and the sharp deterioration of the economic outlook.

*Disclaimer: The views expressed do not necessarily reflect those of the Bank Policy Institute’s member banks, and are not intended to be, and should not be construed as, legal advice of any kind.*

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3 The estimate of the increase in the allowance for credit losses reported in the first quarter due to the adoption of CECL is equal to the sum of the day 1 impact of CECL (after-tax) plus 25 percent of the increase in the allowance between January 2nd and March 31st, 2020. The add-back to earnings is equal to the CECL transition amount across all institutions that have elected to apply the CECL transition provision.