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On Dividend Bans, Banks' Cost of Equity, and Lending

Francisco Covas | July 12, 2021

Last week, the European Central Bank (ECB) published a note analyzing how temporary capital distribution restrictions announced in March 2020 affected bank equity valuations.[1] The note shows that equity valuations for the affected banks fell 7 percent. The ECB also estimates that the cost of equity for the entire banking sector likely increased. The note states that the main driver of the increase in banks' cost of equity is most likely greater uncertainty over future capital distributions, rather than simply the temporary suspension of capital distributions.

As assumed and shown in the entire economic literature on optimal capital regulation, facing a higher cost of capital, banks would reduce lending or raise its cost. The result of the temporary restrictions has thus been a permanent increase in borrowing costs in the EU, and a corresponding permanent reduction in GDP.

The results of the ECB analysis were predictable—and predicted. For instance, in an op-ed in the *Financial Times* on May 24, 2020, Greg Baer wrote:

> . . . a blanket dividend ban imposed outside the current regulatory framework would come with a substantial cost. It would make it difficult for investors to value banks, and thereby make them decidedly less investable.

Also, in response to a paper written by Jeremy Stein and colleagues that advocated for a ban on dividend payments by all banks, we wrote:

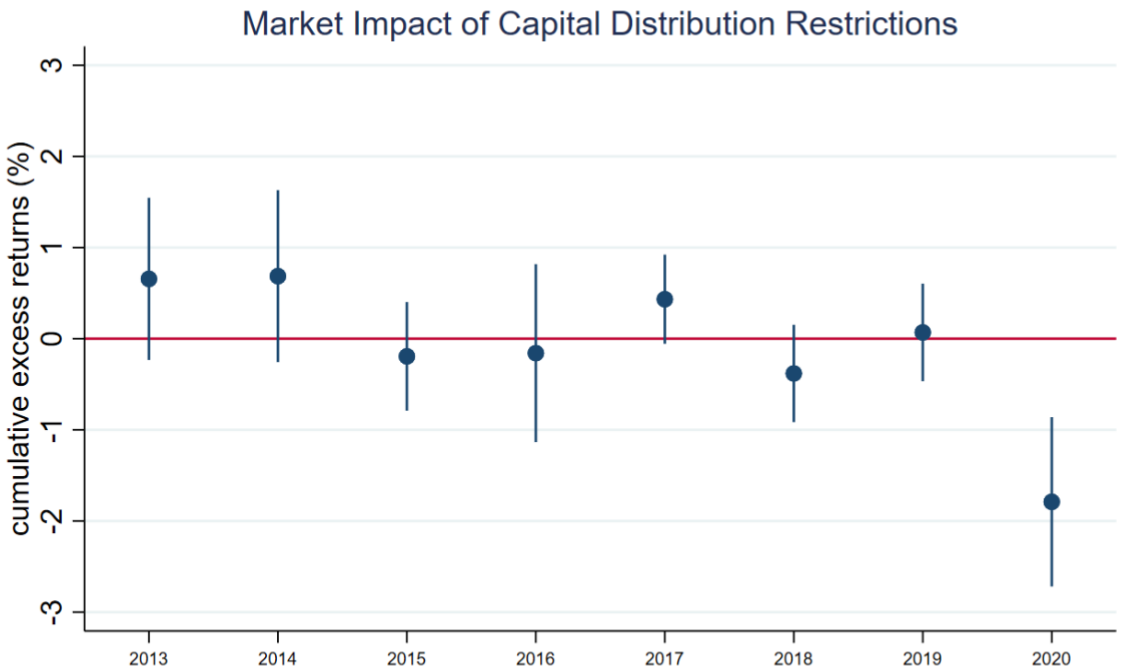
> [O]ne of the first principles of finance is that investors value most highly assets that pay off when times are lean, not when times are fat, so investors would seem likely to find bank stocks less valuable if they knew dividends would always be cut in bad times, raising banks' cost of capital permanently.

The Federal Reserve also imposed restrictions on large banks' capital distributions after the release of the additional stress test analysis in June 2020. The Board required stress-tested banks to suspend share repurchases and imposed an *ad hoc* cap on the growth of dividends. In addition, dividends paid could not exceed average profits over the prior four quarters. At the time of its release, the Board noted the restrictions would stay in place for one quarter and be revaluated quarterly. In the event, the ban on share repurchases stayed in place until the end of 2020, and the capital distribution restrictions ended only after the release of DFAST 2021 results last week.

Following the Fed's announcement that it was imposing blanket restrictions on the capital distributions of large banks, their stocks tumbled relative to the broader S&P 500 index after the markets closed on the next day. As shown in the chart, the cumulative excess returns of stress-tested banks (and thus banks subject to the *ad hoc* restrictions on capital distributions) were lower relative to those of non-stress-tested banks by about –2 percentage points over the 3 days following the announcement. It seems likely that the decline in equity prices

[1] On March 27, 2020, the ECB recommended that euro area banks suspend dividends and share repurchases until October 2020. The recommendation was first extended on July 28, 2020. The second extension was issued on December 15, 2020, and holds until September 21, 2021. Although the communication from the ECB was phrased as a recommendation, it was universally read (including by its authors) as a ban and obeyed as such.

resulted from an increase in the banks' cost of capital rather than a reduction in expected future capital distributions, since a delay in equity payouts should not cause bank valuations to decline.



Note: Each dot indicates the difference in cumulative excess returns between stress-tested banks (and thus banks subject to the *ad hoc* restrictions on capital distributions) and banks not subject to the stress tests. The bars indicate 90% confidence intervals.

Source: Bloomberg, Kenneth French's data library, BPI calculations.

Even though the U.S. departed from the ECB's path by deciding not to impose a *blanket* ban on dividend distributions, the restrictions on capital distributions imposed on U.S. banks went beyond those envisioned by the capital buffer framework. In the past year, we have written extensively about the capital buffer framework's effectiveness in governing capital distributions in stress (see here and here). In particular, that regime explicitly requires a bank to suspend all of its capital distributions if at any time it has insufficient capital to meet its minimum capital requirements under stress.[2] In a recent speech, Board Vice Chair Randal Quarles indicated that the *ad hoc* restrictions are not a practice he hopes to repeat in the future:

> One lesson in particular I wanted to highlight is that our rigorous, forward-looking capital framework, which includes the stress capital buffer, works very effectively. Beginning in the third quarter of 2020, we required large banks to resubmit their capital plans and restricted their capital distributions. . . . While it was sensible at the time, given that this was the first real-world test of our system, for us to use the belt-and-suspenders approach of additional, temporary capital distribution restrictions, we now know that we can have particular confidence in the stress capital buffer framework, as it is informed by a real-time stress testing regime. In the future, having learned the lessons of this test, we will be able to rely on the

[2] Global systemically important banks (GSIBs) need to meet the minimum requirement plus the GSIB surcharge applicable to them.

automatic restrictions of our carefully developed framework when the stress test tells us the system will be resilient, rather than using ad hoc and roughly improvised limitations.

The ECB's recent note demonstrates that *ad hoc* restrictions on capital distributions are a regulatory own-goal. We can hope that the lesson of 2020, and the Vice Chair's promise, will not be forgotten the next time we face economic stress.
