

# BANK DIVIDEND REGULATION: IMPACT OF THE COVID-19 PANDEMIC

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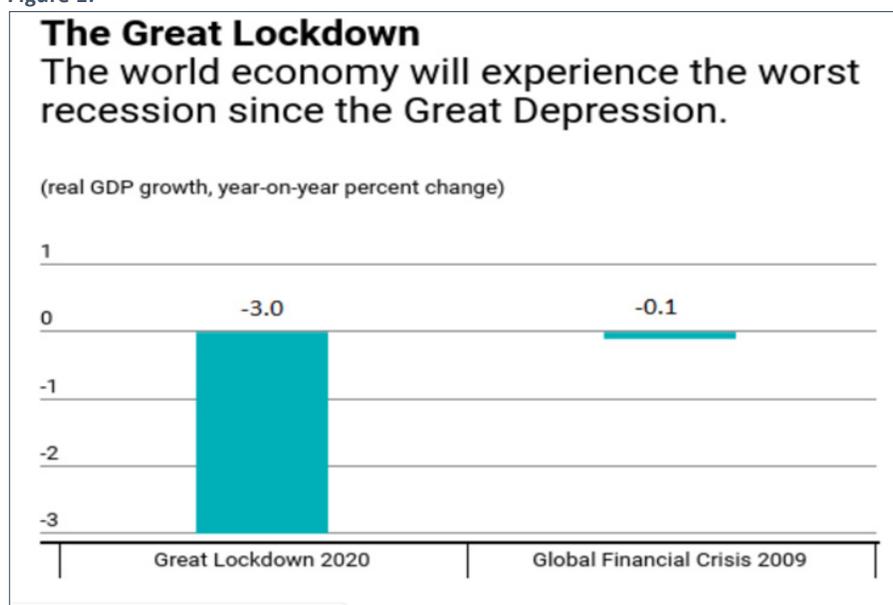
## INTRODUCTION

With the world in the midst of the COVID-19 pandemic that has precipitated a severe global economic contraction, regulators and financial market professionals across the world have moved rapidly to prevent another financial crisis. As part of the regulatory initiatives intended to reduce the real economy impact and financial market strain, some regulators have been calling for coordinated, worldwide action to suspend all bank dividends for the foreseeable future. From our perspective, a blanket prohibition that does not consider how the real economy impact of dividends varies across jurisdictions—depending on banks’ stability, dividend frequency, payout ratio, and the recipients of the funds—risks unintended consequences.

Proponents of dividend suspension are calling for concerted regulatory action to allow banks to build capital and get much-needed funding to businesses and households affected by the COVID-19 pandemic. The intense focus on dividends is heightened by the inability to predict, with any certainty, how long the pandemic will last, or what the shape and durability of the economic recovery will be. For some sectors of the economy facing drastic declines in demand for their products this is an existential threat, with numerous firms unlikely to survive the crisis. There is simply no playbook for putting vast swathes of the global economy on pause.<sup>1</sup>

The International Monetary Fund (IMF) recently revised its World Economic Outlook from growth of 3.3% in 2020 to a severe economic contraction with the global economy falling sharply by 3%. In the IMF’s words: “This makes the Great Lockdown the worst recession since the Great Depression, and far worse than the Global Financial Crisis (GFC).”<sup>2</sup> And this is the new baseline case.

Figure 1:



Similar warnings regarding the severity of the economic contraction are reflected in the forecasts of the world’s central banks and major financial institutions. Preliminary Canadian, European and U.S. data for the first quarter of 2020 have confirmed that the magnitude and speed of the plunge in economic activity is unprecedented in the post-WWII period.

Increased capital will be required for some unpredictable length of time to withstand the surge in credit demand, loan losses, increased expenses, as well as impaired profit. These financial stresses make it essential to bolster the ability of commercial banks to undertake their important policy role in getting much needed liquidity, at record speed, into the hands of large corporations, small and medium-size businesses, and households. In contrast to the GFC, when problems originated in and were dominated by the financial sector, the COVID-19 pandemic is an external shock generating major financial market strains, in particular the massive requirement for liquidity to support the real economy.

**Current Global Situation\***

Funding the global supply chain, making sure accounts receivable and payable do not seize up, is critical to fighting the pandemic and driving economic recovery. Banks’ position as the nerve centre of the global financial system is now pivotal. Central banks’ liquidity support and monetary actions, as well as government fiscal programs, must flow through commercial banks to the real economy.

Central banks are focused upon commercial banks’ support for the real economy as the “last plank in the lending bridge”. Their concerns are twofold: (1) do we have enough liquidity and capital in the system to effectively support the real economy during the coronavirus crisis, and (2) do commercial banks have the infrastructure and operational resiliency to “scale up” rapidly and effectively to disburse the increased liquidity?

The liquidity challenge has ignited a debate concerning the commercial banks’ disbursements via buybacks, dividends, and bonuses. Some regulators are calling for globally coordinated regulatory action to freeze such disbursements. The Systemic Risk Council\*\* wrote to the G20 Finance Ministers and Central Bank Governors in mid March calling for a cessation on all equity buybacks and

dividends, and suspension of bonuses to a “thick layer of highly remunerated staff.”<sup>3</sup> Their call has been echoed by a number of well-respected regulators and analysts.<sup>4</sup>

To date, various jurisdictions are handling the issue differently. The European Central Bank (ECB) has mandated the freeze of dividends, buybacks and bonuses throughout the Eurozone. The Prudential Regulation Authority requested the seven largest banks in the U.K. to suspend dividend payouts and buybacks, and the Reserve Bank of New Zealand asked banks to suspend dividends. The Australian Prudential Regulation Authority made a strong recommendation that suspending dividend payouts bears consideration although they have not yet mandated it. In the U.S., eight of the largest banks have agreed to suspend buybacks, but are still staunchly defending the payout of dividends although some cautionary notes are being sounded.<sup>5</sup>

**1. RATIONALE FOR UNIFORM DIVIDEND SUSPENSION**

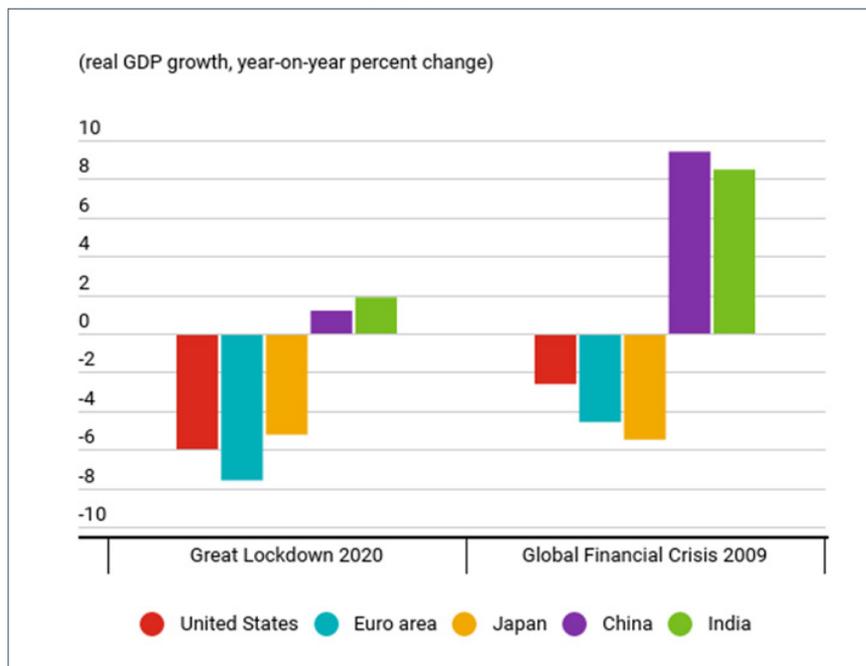
**Global Increase in Demand for Capital**

Advocates cite a series of reasons to consider a coordinated global regulatory approach, beginning with recognizing that this is a global crisis. The Great Lockdown impacts everyone, unlike the GFC in which most advanced economies suffered a deep recession but a number of recently developed economies did not.

\* For a comprehensive review see: Global Survey of Dividend Policy during COVID 19 <https://globalriskinstitute.org/publications/global-survey-of-dividend-policy-during-covid-19-2/>

\*\* The Systemic Risk Council is a private sector, non-partisan body of former government officials and financial and legal experts committed to addressing regulatory and structural issues relating to global systemic risk.

Figure 2: Major Economies are Facing Significant GDP Declines<sup>6</sup>



Banks have multiple roles to play in supporting the economy and providing pandemic relief. Consumers and businesses alike will draw down on credit facilities. Default risk, and subsequently loan losses, will increase and need to be absorbed.\* Other adverse impacts will arise from market losses, reduced profits through mortgage payment deferrals, a reduction in various fee-generating activities, and non-interest expenses that may increase as banks re-configure to work-from-home protocols to protect their employees and customers’ health. In addition, banks are being called on to play a public policy role in operationalizing governmental fiscal support.

**Uncertain Magnitude and Duration of the Crisis**

No one can predict how long the economic contraction will last, or what the re-opening of economies will look like, and how durable the post-crisis recovery and subsequent expansion will be. For proponents, the “better safe than sorry” adage applies: there will be no ability to claw back dividends that have been paid out, so stop them now. As Janet Yellen said, “If we’re wrong, we can always pay them

back later through a special distribution.”<sup>7</sup> IMF projections show that loan losses will be worse than they were during the GFC, and probably higher than the banks worst-case stress test scenarios. Experts predict profit in the banking sector could fall by 25% or more over the next 12-18 months.<sup>8</sup> In view of this extreme level of uncertainty, it is argued that protecting and shoring up capital now is imperative.

*“Banks will bear a large part of the burden that will come from the economic disruption of the coronavirus pandemic. They will need to support lending to households, businesses and large corporates. To weather the storm, they must build their balance sheets into fortresses and use every means to shore up capital.”*

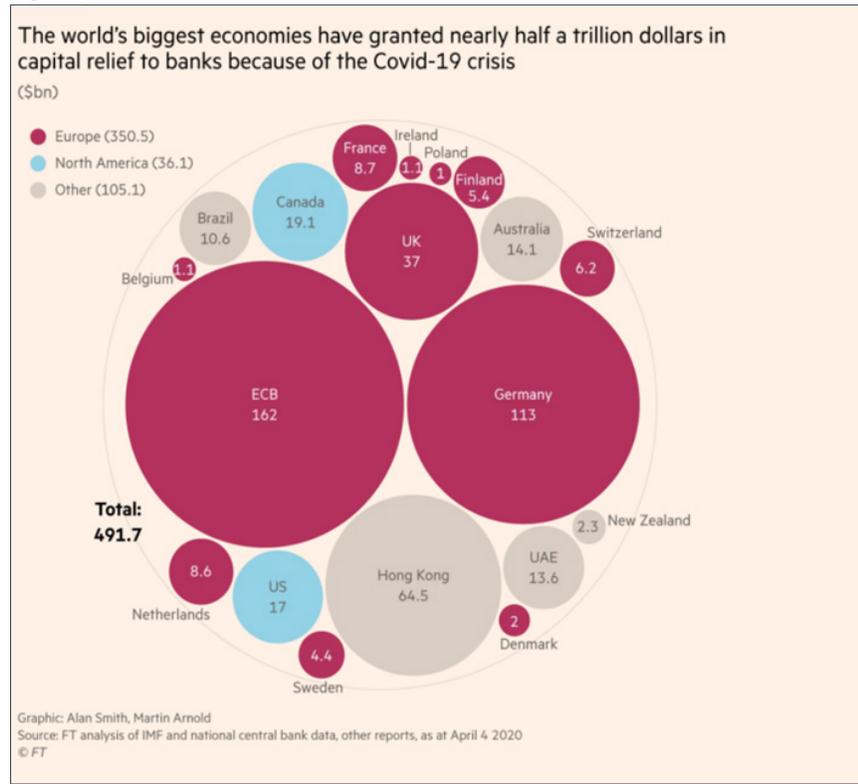
*-Victoria Jones, Financial Times, March 30, 2020*

**Moving the Dial**

Dividend payouts can be substantial. Due to the leveraging effect, their addition to capital can materially increase lending capacity. Regulators have already taken swift action to provide banks with capital relief to spur lending in Canada, the U.S., continental Europe and the U.K.

\* Several large US banks have already increased their provisions for credit losses by 350%, year-over-year to \$US 24 billion (Globe and Mail, April 20,2020.)

Figure 3:<sup>9</sup>



Given the scale and speed of the pandemic’s financial shock, key funding markets experienced acute stress. Central banks rapidly took a wide range of measures to sustain the supply of credit and support financial intermediation. Policy lending rates have been dropped by 150 basis points in Canada and the U.S. Other jurisdictions such as the EU and U.K. — where there was little room to move — nevertheless made smaller but notable cuts.<sup>10</sup> Almost all major jurisdictions now have rates that are de facto zero; some have negative lending rates. Beyond this traditional monetary easing, central banks have either undertaken their first-ever quantitative easing (QE), or massively increased their QE initiatives through huge asset purchase programs covering a much broader range of eligible securities.

Central banks’ action, flooding the market with liquidity, has helped enormously in stabilizing financial markets through April. However, central banks cannot deliver solvency; they cannot underpin household incomes or insure businesses against this large scale collapse in demand. Ensuring the functioning of the global supply

chain requires a rapid and sustained infusion of credit. Government fiscal programs and support from commercial banks can do this, but the banks need capital to support this vital activity. By way of illustration, assuming an average leverage rate of 16:1, the \$US 500 billion freed up through a dividend freeze would support \$US 8 trillion in global supply chain funding.<sup>11</sup>

### Sector-Wide Cover

Finally, some supporters of a coordinated approach argue that mandated dividend suspension for all globally systemically important banks (G-SIBs) would relieve pressure on any one bank having to suspend its dividend, thereby avoiding the stigma of individual banks signalling weakness. If any banks fail and need to be bailed out during this crisis, the outcome has serious repercussions for all banks with adverse spill-over for the whole sector. Uncoordinated action could cause unnecessary pressure on stock prices in a sector where share values have already fallen markedly, making it harder to raise capital if needed.

## 2. RATIONALE FOR DIFFERENTIATED APPROACH

Despite this logical set of arguments to support concerted action, a closer examination shows there are important differences between markets which cast doubt on the wisdom of a uniform approach. Many elements of the global financial system have been materially strengthened as a result of the regulatory reforms implemented in the aftermath of the GFC.<sup>12</sup> This greater resilience of major banks may allow the system to absorb, rather than amplify, the current macroeconomic shock.

### Differing Strength of Banking Sectors

Strength in both central and commercial banks' balance sheets and capital positions differs significantly among jurisdictions. The Bank of Canada's (BoC) balance sheet was 5% of GDP prior to the Great Lockdown, in comparison to 24% for the Fed, and 39% at the ECB.<sup>13</sup> In Europe, various banks required nationalization or massive bailouts during the GFC, and a number have struggled with the weak economic growth of the Eurozone over the past decade. Overall, the Eurozone has significantly less monetary ammunition and less bank capital strength than North America.

In March, the ECB required banks to refrain from paying dividends until at least October 1, 2020 to free up €30bn of additional capital to help support lending.<sup>14</sup> The seven largest banks in the U.K. coordinated their compliance to a strong request from the Prudential Regulation Authority to suspend dividends. Considerable backlash resulted with HSBC retail shareholders in Hong Kong pressing for an extraordinary general meeting to oppose the suspension.<sup>15</sup>

The general sentiment, established in late April, is that US bank dividends will be paid. Market analysts view U.S. commercial banks as well capitalized (average 13% Tier 1 ratio pre-crisis)<sup>16</sup> to withstand loan losses that will occur. Suspending share buybacks—which the eight largest banks have agreed to—will add substantial incremental liquidity, (about \$US 110 billion).<sup>17</sup> Accordingly, curtailing dividends appears unnecessary at this juncture.

Canada's banking sector is viewed as having bedrock stability, steadier yields and ample capital, coming into the pandemic with an average 11.6% Common Equity

Tier 1 ratio (CET1). The consistency of Canadian bank quarterly dividend payments is almost unmatched around the world. With one exception among Canada's largest six banks, there have been no dividend suspensions for more than 100 years (National Bank cut its dividend in the early 1980s and again in the early 1990s). A recent RBC assessment of the fate of dividends during the economic stress caused by the pandemic rated Canadian banks as having a "high" likelihood of continuing to pay their dividend.<sup>18</sup> The major banks' CEOs remain bullish about the payment of dividends.

### Global Cooperation Shows Some Strains

The Financial Stability Board (FSB)<sup>19</sup> has undertaken a broad range of initiatives to promote a rapid and coordinated response to support the real economy and maintain financial stability. However, there are some structural signs that multilateral cooperation may not be what it was during the GFC. Political pressures within the EU, and a growing trend toward isolationism in some major advanced economies are warning signals that international coordination may not be as robust in 2020. The flexibility that has been built into existing regulatory standards will no doubt be exercised differently across jurisdictions, making an attempt at regulatory solidarity on bank dividend suspension a riskier proposition.

### Diverse Role of Dividends

Across the financial sector there is considerable diversity in shareholder composition, stability of payment dividends, and the value of dividends in relation to share buybacks, as seen in Table 1. The timing, reliability, and distribution impact of dividend disbursements need to be considered given the consequences for recipients. For banks that pay quarterly, there is more flexibility in the timing of dividend-related decisions.

The impact on the economy also matters a great deal. Do dividend payments contribute more to economic resuscitation in a given economy through support for lending? Does taking bank dividend income away materially impact retail investors challenged in seeking income from the few high-quality investment alternatives available with ultra-low government bond yields?

**Table 1: Dividend Comparison\* (\$ billion)**

Jurisdiction	Dividend Distribution Cycle	Stability of Payment	Dividend Recipients	Average Banking Sector Payout Ratio**	Sector Dividends Distributed (\$B)
Australia	Semi annually	Recent cuts in dividends due to low sector eps, dividend growth rate in the has been (2.5% over the past five years)	Retail investors	93%	\$A 33.5
Canada	Quarterly	No disruption for more than 100 years by largest five banks	70-80% Canadians, > 50% retail investors	47%	\$Cdn 22.5
Eurozone	Annually or semi-annually	Variable across wide variety of banking institutions	Diverse mix of government, other FIs, institutional investors, cooperative movements	55%	€30.0***
U.K.	Semi-annually 1/3payout followed by 2/3 payout	Variable, more use of special dividends, dividend suspensions in some cases post GFC	Mix of government and retail ownership; <2% institutional Investors	80%	\$US 19.5
U.S.	Quarterly	Relatively frequent increases/ decreases	70%-80% institutional investors	32%	\$US 55

The impact of dividends on the real economy varies across jurisdictions depending upon the frequency, stability, payout ratio and the recipients of the funds.

## CONCLUSION

As other GRI work<sup>20</sup> has shown, regulators have tailored their responses regarding bank dividends during the pandemic to their respective jurisdictions' economic and financial circumstances. This differentiation is noteworthy, as have been the coordination efforts of the FSB.

The debate continues between proponents of further coordination to suspend dividends across all major jurisdictions for G-SIBs at minimum, and those who hold the opposite view favouring continued differentiation as circumstances warrant. From our perspective, the intention of a coordinated international regulatory response is commendable as a global objective. But uniformity of purpose need not necessarily translate into a uniformity of approach.

\* This table is generally indicative; it will not represent all cases

\*\* Trailing 12 month average; source: <https://www.gurufocus.com/> and <https://www.morningstar.com/>

\*\*\* Planned but suspended 2019 dividends

In our view, applying a single approach to dividend regulation assumes greater similarity in circumstances without taking into consideration the differences in underlying conditions in the banking sector among Europe, the U.K., U.S. and Canada. A uniform approach may risk undermining support for important global coordination in other aspects of financial regulation. A blanket prohibition also risks significant unintended consequences at this stage of the global pandemic crisis. Barring a serious threat to sufficient bank capital to sustain these intermediaries' much-increased lending and liquidity roles during the COVID-19 crisis, dividend regulation should reflect individual country and regional needs.

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## ENDNOTES

- 1 See for example, Fed Chairman Jerome Powell's April 29<sup>th</sup> 2020 press conference remarks on the importance of maintaining the flow of credit to households and businesses during the crisis to support the U.S. economy's future recovery.
- 2 <https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/>
- 3 <https://www.systemicriskcouncil.org/2020/03/src-statement-on-financial-system-actions-for-covid-19/>
- 4 <https://www.ft.com/content/ed87b5d6-6a8e-11ea-a6ac-9122541af204>  
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<https://www.risk.net/regulation/7522861/fed-missed-chance-to-curb-dividends-say-ex-supervisors>
- 5 <https://www.jporganchase.com/corporate/investor-relations/document/ceo-letter-to-shareholders-2019.pdf>
- 6 <https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/>
- 7 <https://www.wsj.com/articles/fed-unlikely-to-order-big-u-s-banks-to-suspend-dividends-sources-11585941449>
- 8 <https://www.marketwatch.com/story/bank-earnings-preview-as-industry-profits-get-cut-in-half-the-winners-will-emerge-next-year-2020-04-07>  
<https://www.theglobeandmail.com/business/article-canadian-banks-face-earnings-hit-as-analysts-predict-rising-loan-loss/>
- 9 <https://www.ft.com/content/9a677506-a44e-4f69-b852-4f34018bc45f>
- 10 National Bank of Canada: Economics and Strategy Monthly Fixed Income Monitor — April 2020
- 11 <https://www.ft.com/content/9a677506-a44e-4f69-b852-4f34018bc45f>
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- 13 National Bank of Canada: Economics and Strategy Monthly Fixed Income Monitor — April 2020
- 14 <https://www.theglobeandmail.com/business/international-business/article-uk-banks-scrap-dividends-on-coronavirus-fears-pressure-on-bonuses/>
- 15 <https://www.ft.com/content/3681a998-8164-4fd1-a5e5-ae54f56a3b70>
- 16 <https://www.euromoney.com/article/b1kxrvx42r38r6/can-banks-withstand-the-impact-of-covid-19>
- 17 <https://www.ft.com/content/09ae1b36-1c8d-477e-b08f-3955984fd83b>
- 18 RBC Capital Markets, Dividend Sustainability in Canada, Banks and Lifecos, March 30, 2020
- 19 <https://www.fsb.org/2020/04/covid-19-pandemic-financial-stability-implications-and-policy-measures-taken/>
- 20 <https://globalriskinstitute.org/publications/global-survey-of-dividend-policy-during-covid-19-2/>