Opinion **Banks**

The bank dividend ban has failed and should be lifted

Regulators have unwittingly weakened rather than strengthened European lenders

SIMON SAMUELS

José Antonio Alvarez, chief executive of Santander, wants to resume dividend payments to shareholders © Angel Navarrete/Bloomberg

Simon Samuels NOVEMBER 16 2020

The writer is a banking consultant at Veritum Partners

Back when the British government imposed colonial rule over India, its leaders wanted to cut down on the population of deadly cobras in Delhi. So the government offered a bounty for every cobra carcass. Delhi residents responded rationally — they began breeding cobras to claim the rewards.

When the government scrapped the reward scheme in response, the breeders set their now worthless reptiles free, driving up the feral population.

This cautionary tale comes to mind when considering the decision earlier this year by European banking regulators to force banks to cancel dividend payments. It is also producing an effect that is the exact opposite of what was intended, and despite the news last week that Swedish regulators may allow their banks to resume dividend payments next year, that may be too late to correct the unintended damage.

On the face of it, cancelling dividends made sense. In March, almost 70 European banks were expected to pay around €60bn in dividends to their shareholders during 2020. Halting those payments would help preserve their capital, leaving them better equipped to deal with the feared economic damage from Covid-19.

Banks across Europe complied, led by a new generation of chief executives keen to demonstrate that in the pandemic crisis — unlike the financial crisis of 2008 — they would be part of the solution, not the problem.

Investors were not happy. Since late March, the combined market capitalisation of the 66 largest banks in Europe has fallen by €250bn, or almost 25 per cent. That's largely because dividends are one of the key reasons to buy bank shares. Unsurprisingly, banks are itching to resume payments; Santander's chief executive José Antonio Alvarez said recently, "we are making our case".

These unintended consequences make it a version of the cobra effect. Banks need capital to support lending to customers. They can generate it internally from making profits or externally by raising more money from shareholders. While cancelling dividends kept €60bn of extra capital in these banks, the resulting plunge in their share prices has badly damaged the ability of all lenders to raise fresh capital. That means banks' overall access to new capital is worse now than it was before the regulators intervened.

Not all of the €250bn loss in value is due to the dividend ban, but it has been a big driver and the damage will linger. Bank share prices won't simply reset once the ban is lifted. Instead, investors will tread even more warily as they factor in the risk of similar future regulatory interventions.

In the long term, the blanket ban appears to confirm investors' worst fears about the opacity and complexity of banks, with regulators either unwilling or unable to differentiate between strong lenders and weak lenders.

It also undermines the value of the regular stress tests that regulators do as a means of preparing banks for massive shocks. And in countries such as the UK, safeguards provided by "ringfencing" structures were supposed to allow banks to fail safely, without recourse to taxpayers or causing broader systemic risk. Yet when a crisis loomed, these measures were not considered strong enough.

The ban has also returned banks to an unhealthy "parent-child" relationship with regulators, undoing efforts to create a more mature, trusting association.

The dividend ban has failed. It has rationed, not increased, banks' access to capital; it will damage valuations for a long time; it has raised questions over regulators' ability to regulate; and it has unhealthily undermined the relationships between banks and their regulators. Like the British government trying to rid Delhi of cobras, those in charge may inadvertently have made things worse.