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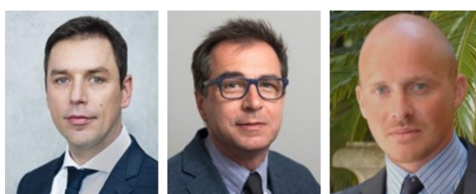
On the effectiveness of dividend restrictions as supervisory policy tool*



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Perhaps one of the worst failures of banks' corporate governance has been the continued payment of dividends during the Great Financial Crisis (Acharya et al., 2009). Fast forward a decade, at the onset of the coronavirus (COVID-19) pandemic, central banks and supervisors introduced dividend restrictions as a new policy instrument. This measure aimed to support lending to the real economy and enhance banks' capacity to absorb losses in the face of economic shocks. In our study, we estimate the impact of the ECB's dividend recommendation on bank lending and risk-taking. Our findings indicate that dividend restrictions have been an effective policy in supporting financially constrained firms, adding capital space to banks, and limiting procyclical behaviour. The effects on lending are greater for small and medium-sized enterprises and for firms operating in sectors more vulnerable to the effects of the pandemic. However, we do not find evidence of a significant increase in lending to riskier borrowers and "zombie" firms. These findings show that dividend restrictions can serve as an additional and effective countercyclical policy tool during times of crisis.

*The views in this paper are those of the authors only and do not necessarily reflect those of the BIS or the ECB.

Introduction

On 27 March 2020 the ECB adopted a recommendation asking euro area banks not to pay out dividends, at least until 1st October 2020. The objective of the recommendation was to boost credit institutions' capacity to absorb losses and to nudge them to continue funding households and SMEs during the pandemic.[1]

We investigate the recommendation's impact on the credit supply to non-financial corporations (NFCs) amid the Covid-19 economic shock. Banks' management bodies effectively faced a choice of how to allocate their capital when deciding whether to follow the ECB recommendation, with different implications for the credit supply. On one hand, given constant demand and price effects, they might have opted to use the surplus capital to increase lending supply, thus responding countercyclically to support the economy. On the other hand, they might have decided to increase their resilience to future shocks by saving capital, and/or strengthening their loss-absorption capacity by making additional provisions. Of course, they could have opted also to postpone any distribution for the time the ECB would lift the recommendation. Therefore, the policy question is to what extent the ECB's dividend recommendation was effective and led to an increase in credit supply to NFCs, and whether this effect varied for different types of firms and sectors.

To answer this question, in Dautović, Gambacorta and Reghezza (2023) we compare the credit supply of banks affected by the ECB recommendation with a control group of unaffected banks. To tackle identification issues, we rely on credit registry data and a measure that captures differences in compliance with the dividend recommendation among euro area banks. The analysis disentangles the confounding effects stemming from the wide range of monetary and fiscal policies that supported credit during the Covid-19 downturn and investigates their interaction with the dividend recommendation.[2]

The effects of the ECB recommendation on bank lending and risk

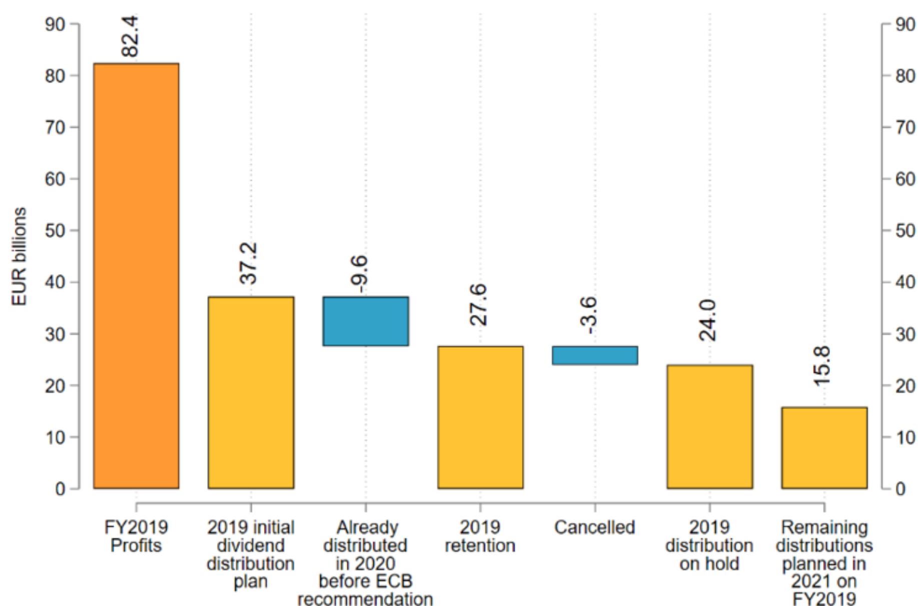
The ECB recommendation was issued in an environment in which firms tend to distribute a substantial percentage of their earnings as dividends. Figure 1 illustrates the cumulative planned dividend distributions prior to the ECB recommendation and the extent of compliance with the policy.

While dividends serves as a legitimate means of distributing private corporate profits to shareholders and normally contribute to efficient allocations of savings and capital, empirical evidence suggests that during times of crisis, banks tend to increase dividend distributions as a signalling mechanism, thus acting in a procyclical manner (Acharya et al., 2012; Abreu and Gulamhussen, 2013; Wu, 2018). This suggests that, in a severe crisis, and from a wider social standpoint, dividend restrictions can be justified to encourage banks to preserve capital and support lending to the real economy.

[1] See the ECB press release of 27 March 2020. This was followed by an statement from the European Banking Authority on 31 March 2020. Many national competent authorities subsequently issued their own regulatory announcements in a similar vein.

[2] To control for the confounding effects of monetary policy measures on lending we use the ECB dataset on targeted long term refinancing operations (TLTROs) to control for ECB long term funding provided to banks. We also use the deposits held by banks at the ECB as a measure of the take-up of Asset Purchase Programs (APPs) and Pandemic Emergency Purchase Programme (PEPP). To control for fiscal policy measures, we match the euro area credit registry data with bank-firm level information on payment moratoria and government guarantees schemes.

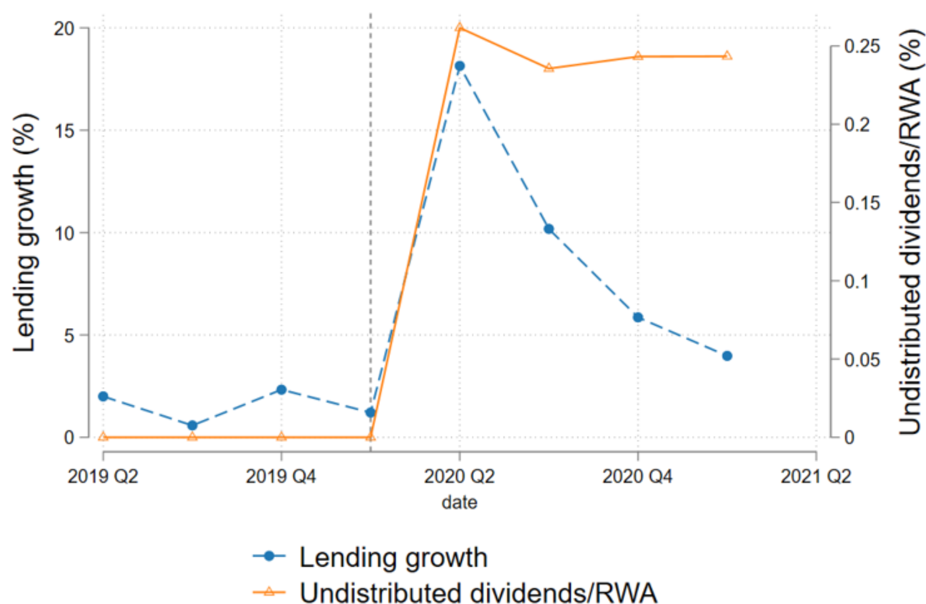
Figure 1: Dividend distribution plans of significant institutions



Source: ECB banking supervision survey on dividend distribution plans.
Notes: The chart plots the aggregate evolution of dividend distribution plans of significant institutions in the euro area as of March 2020. From the initial plan to distribute €37.2 billion, banks had already distributed €9.6 billion in the first three months of 2020. As of March 2020, the amount of planned but not yet distributed dividends comprised the 2019 retention.

Figure 2 shows the co-movement of credit growth and the planned but non-distributed dividends scaled by risk-weighted assets (RWAs). It is noteworthy that the growth rate of lending increased in the quarter following the pandemic outbreak, with an unconditional average of 18.1%, before declining monotonically in the subsequent quarters. As expected, the amount of non-distributed dividends over RWA also spiked immediately after the ECB recommendation, remaining persistent until the end of 2020 at 0.24%.

Figure 2: Credit growth and undistributed dividends



Source: ECB supervisory survey on dividend plans and supervisory reporting.
Notes: The chart illustrates the evolution of the credit growth and the planned but not distributed dividends as a share of RWAs. The sample includes all banks. Lending growth is the percentage change compared with the previous quarter, while undistributed dividends are expressed as a percentage of RWAs. The dashed vertical line is at the first quarter of 2020, the time of the ECB dividend recommendation.

Controlling for other confounding factors, our results show an overall positive effect of the ECB's dividend recommendation on euro area banks' credit supply to NFCs. We find that dividend restrictions have been an effective policy in supporting financially constrained firms, adding capital space to banks, and restricting some forms of procyclical behaviour. In particular, the study finds that a 1 percentage point increase of the ratio of non-distributed but planned dividends over RWAs has contributed to an additional 4.4. percentage points in the growth rate of euro area credit supply to NFCs. The effects on lending are larger for small and medium enterprises and for firms operating in sectors that were exposed to the effects of Covid-19, suggesting that banks channelled the surplus capital to those firms most affected by the pandemic-related lockdowns. We also find evidence that the dividend recommendation has sustained bank lending even in the absence of government guarantees.

At the same time, we do not find evidence of a significant increase in lending to riskier borrowers and ”zombie” firms. Specifically, lending growth stemming from the non-distributed dividends is estimated to be *lower* when a bank-firm relationship has accumulated impairments, and is null in the case of “zombie” borrowers (i.e. those having above the 95th percentile of impaired loans with a specific bank). The lending growth is lower also for banks with high non-performing loan (NPL) ratios. Furthermore, we find that the impact of the ECB's dividend recommendation is short-lived: the beneficial effect disappears in the fourth quarter of 2020 and is primarily concentrated in the second and third quarters of 2020.

Policy implications

Dividend restrictions can be an effective and proven countercyclical supervisory policy tool during an economic downturn (when NFCs suffer liquidity shortages), and potentially in financial crisis as well (Acharya et al., 2012). These restrictions can sustain credit growth and yield positive real effects, although these effects may be short-lived. The impact of dividend restrictions tends to be stronger for SMEs and more vulnerable sectors of the economy. Additionally, dividend restrictions can enhance the effectiveness of countercyclical policies in a downturn, showing strong complementarities with government guarantees as fiscal policy measure.

From both distributional and macroeconomic perspectives, implementing a dividend restriction policy can effectively redirect resources from excessive shareholder consumption to credit supply. Recent evidence suggests that investors' consumption is excessively influenced by dividend distribution (Bräuer et al., 2022). Our findings show that undistributed dividends are channelled into loans to firms, which likely have a higher growth multiplier compared to consumption.

However, it is crucial for dividend restrictions to be temporary in nature to mitigate unintended policy effects, and clear supervisory forward guidance should accompany them. Transparent communication regarding their duration and the rationale behind their implementation can help minimise inefficiencies resulting from an uncertain policy environment. Falling to provide such clarity can undermine financial stability.

Dividend restrictions offer additional benefits during times of crisis. They can simultaneously increase solvency (capital) and enhance loss-absorbing capacity (loan loss provisions). This, in turn, reduces the potential costs borne by debtholders and potentially taxpayers in the event of a bail-in. Moreover, dividend restrictions complement and address concerns associated with the release and use of macroprudential buffers, as buffer releases can be, at least in principle, (mis)used to increase dividend distribution.[3]

[3] The (mis)use of policy stimulus has been studied also for the case of NFCs. Todorov (2020) shows that NFCs which benefited from the ECB's Corporate Sector Purchase Program mostly increased dividend payments, rather than real investments. A dividend restriction policy at the time might have been helpful to avoid this negative externality.

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