High time to tell European banks: No dividends

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In October 2014, the European Banking Authority (EBA) and the European Central Bank did a comprehensive assessment of the balance sheets of the largest 123 banks in the Eurozone. They calculated a capital shortfall of €25 billion across all banks based on losses in adverse stress scenarios. Banks were required to hand in plans on how to address these shortfalls within a six- to nine-months window. Some banks took action and raised equity through rights issues, sometimes with substantial involvement of the government such as in the U.K. Mostly, however, banks improved their regulatory capital ratios by reducing holdings of assets deemed risky under the capital standards.

Whatever these measures were, they have not successfully solved the problems of the banking sector. European banks' share price has declined by 50% on average since the 2014 assessment. Either banks that failed the stress test in 2014 did not take the outcome seriously, or the regulators did not sufficiently enforce actions, or more likely, the stress tests were too meek to start with.

The EBA has now disclosed the results of the latest stress test on July 29th, 2016. In contrast to earlier tests, this test was not designed to identify capital shortfalls in banks that required immediate attention. The results are supposed to provide supervisors with information that might be useful in the supervisory process going forward.

After the stress test, the regulators conjectured that the European banking sector is resilient to adverse shocks. Only Banca Monte dei Paschi di Siena failed with a capital requirement of €5.6 billion, an amount similar to the capital increase announced by the bank on the day of the stress test release.

The absence of a clear estimate of the capital shortfalls of European banks and a recapitalization plan appear to have contributed to a negative market reaction. The European banking sector index EuroStoxx Banks fell about 7.5% in the two days following the announcement of the stress test results.

In independent work that helps understand this market reaction, we identify a capital shortfall of European banks participating in the EBA stress test of 2016 of about €123 billion to satisfy the same capital requirements as large U.S. banks.

However, and despite this capital shortfall, 28 of the 34 publicly listed banks in the stress test have paid out about €40 billion dividends for 2015. These banks pay out, on average, more than 60 percent of their earnings to shareholders.

Allowing under-capitalized banks to pay out dividends represents a substantial wealth transfer from subordinated bondholders to shareholders as it increases the likelihood that bondholders will need to be bailed in. Moreover, it is ultimately a wealth transfer from the taxpayer to the shareholders as state-aid is possible under the new restructuring rules after 8 percent of equity and liabilities have been bailed in.

In stark contrast, the immediate sanction applied to undercapitalized banks in annual U.S. stress tests is to force banks to stop any form of capital distribution. This is a sanction envisaged by the EBA following the results of the 2016 stress test. The EBA explicitly states that “competent authorities may also consider requesting changes to the institutions' capital plan. Such changes may take a number of forms such as potential restrictions on dividends required for a bank to maintain the agreed trajectory of its capital planning in the adverse scenario”. Our estimates suggest that if European supervisors had adopted this approach and forced banks to stop paying dividends in 2010 (which marks the start of the sovereign debt crisis in Europe), the retained equity could have funded more than 50 percent of the capital shortfalls we estimate in 2016.

Figure 1 shows the capital shortfalls that we calculated using the losses in the adverse scenario in the 2016 EBA stress test and the cumulative dividends these banks have distributed since 2010. Dividends paid out by some banks such as BNP Paribas and Barclays even exceed the current capital shortfalls. At others such as Deutsche Bank, Commerzbank or Société Générale, dividends if retained would have covered only a smaller percentage of the capital shortfalls. These banks would require substantial capital issuances on top of dividend restrictions to cover the shortfalls.

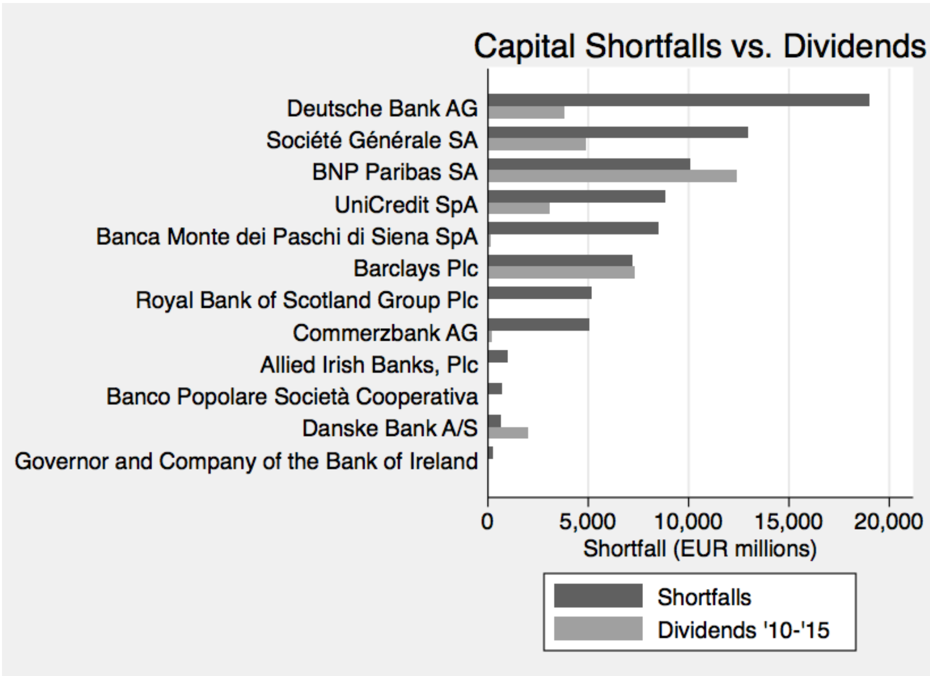

Figure 1. Capital shortfalls and dividends

A first step to preventing bank capital erosion can be that simple: ask banks to stop paying dividends! And it wouldn't even require a discussion about capital issuance or bail-in or bail-out. Some banks have already taken steps and suspended dividend payments. It is now the task of the European Central Bank to enforce this across the Eurozone.