MONETARY AND CAPITAL MARKETS

Special Series on COVID-19

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Restriction of Banks' Capital Distribution during the COVID-19 Pandemic (Dividends, Share Buybacks, and Bonuses)

Rachid Awad, Caio Ferreira, Aldona Jociene, and Luc Riedweg[1]

At the current stage, the severity of the impact of the COVID-19 epidemic on the financial sector is highly uncertain. Initial estimates, however, suggest that the impact on the macroeconomic environment will likely be substantially more adverse than the stress test scenarios used by most supervisory authorities to assess the capital adequacy of financial institutions. In this context, to ensure that the banking sector continues financing the real economy and has enough resources to absorb losses, it is recommended on grounds of prudence that supervisory authorities take actions to preserve banks' capital resources by temporarily limiting the distribution of capital (dividends, share buybacks, and discretionary bonus payments) for all banks, until the impact of the pandemic becomes clearer.

I. WHY RESTRICT CAPITAL DISTRIBUTIONS DURING THE COVID-19 PANDEMIC?

Current International Framework

The implementation of the postcrisis standards improved the capitalization of the banking sector, so that banks entered the pandemic much stronger.[2] The postcrisis regulatory reform also introduced capital buffers to help banks to withstand stressed situations such as the COVID-19 pandemic.[3] When buffers are drawn down to pre-identified levels, the Basel standards place automatic limits on distributions of dividends, share buybacks, and discretionary staff bonus payments, which facilitate the preservation of capital and the rebuilding of buffers. Supervisory authorities must ensure that banks' dividend distribution planning is revised accordingly and bank shareholders, rather than depositors, bear the risk of losses and of ultimate recovery.

[1] For more information, contact Rachid Awad (rawad@imf.org), Caio Ferreira (cferreira@imf.org), Aldona Jociene (ajociene@imf.org), and Luc Riedweg (lriedweg@imf.org).

[2] Globally banks had roughly US$5 trillion of capital above their Pillar 1 regulatory requirements. See "Releasing Bank Buffers to Cushion the Crisis—A Quantitative Assessment." BIS Bulletin No. 11. 2020. https://www.bis.org/publ/bisbull11.htm

[3] "Risk-Based Capital Requirements." The Basel Framework. Basel Committee on Banking Supervision. 2020. https://www.bis.org/basel_framework/.

International standards also require that supervisory authorities have a range of tools to take corrective measures.[4] These tools include restricting or suspending capital distributions, when a bank is not complying with prudential requirements, and/or is engaged in unsound practices or when the interest of depositors is threatened. According to the Basel Core Principles, supervisors should act at an early stage to require a bank to take action to prevent it from reaching its regulatory threshold requirements.

Given the potential large losses that might arise from the pandemic, supervisors need to halt banks dividends and share buybacks now, even if pre-identified capital limits have not been breached. [5] Retaining earnings from ongoing operations, across the entire banking sector, is vital to ensure strong capital positions that support the appropriate function of the banking sector.

II. POTENTIAL BENEFITS OF ADDITIONAL RESTRICTIONS

- A prudent and forward-looking stance to restrict distributions would help to preserve capital resources within the banking system, which would enhance its capacity to support the real economy during the COVID-19 pandemic and to absorb the significant losses that may arise in the period ahead. [6] It is crucial that banks can continue financing households, small and medium businesses and corporates, which are facing extraordinary challenges. Increasing the resilience of the banking system to the severe shock (which may be larger than built into recent supervisory stress tests) would support this key objective.
- Although supervisors have encouraged banks to use their capital buffers to absorb losses and provide credit to the economy, some banks are reluctant to use them because of the potential stigma associated with the signals implied by the automatic restrictions for capital distributions.[7] A sector-wide restriction of distributions would eliminate the collective action problem and reduce stigma, increasing the likelihood that the capital buffers will be actually used.
- Preserving capital across the entire banking sector is aligned with the array of actions undertaken to stabilize the economy. Governments are deploying fiscal packages to support nonfinancial firms. Central banks have innovated and provided extraordinary liquidity support to a wide range of markets. Banks supervisors have exercised flexibility to the fullest possible extent by encouraging banks to restructure loan repayments, easing regulatory requirements, and allowing banks to draw down their buffers. In this regard, it is important to guard against the risk that banks might not be able to continue performing their role in the financial sector. All stakeholders will ultimately benefit if banks preserve capital now instead of paying out to shareholders.
- Prudent supervisory measures to restrict capital distributions would help banks to accumulate capital resources during the pandemic. Post global financial crisis regulatory reforms enhanced the ability of banks to withstand shocks and, in many jurisdictions, banks enter this period with a relatively strong capital position. While restricting distributions will prevent shareholders from receiving dividends now, it is an important precautionary step to provide additional room for banks to support the economy as well as to mitigate the risk that governments are called on to provide financial support to recapitalize banks at a subsequent stage. Any bailout of banks by taxpayers after being allowed to pay dividends would be

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[4] "Core Principles for Effective Banking Supervision." Basel Committee on Banking Supervision. 2012. https://www.bis.org/publ/bcbs230.htm.

[5] "Kristalina Georgieva: Halt Bank Dividends and Buybacks Now." *Financial Times*, May 21, 2020. https://www.ft.com/content/d85a29fc-9926-11ea-871b-edeb99a20c6e

[6] Buybacks and dividends at the world's 30 largest banks reached $249 billion in 2019 (including $155 billion for the eight US G-SIBs—global systemically important banks), which is a substantial amount compared to CET1 capital levels (almost $800 billion of CET1 for the US G-SIBs). A suspension of all forms of distribution for a longer period (one year) would therefore have a material impact on banks' capital levels.

[7] Under the capital conservation buffer, whenever the capital ratio of a bank falls below the buffer target, the bank is automatically required to constrain its capital distributions in the subsequent period (that is, limit pay out of dividends, share buybacks, and discretionary bonus payments) so that the buffer can be replenished. The distribution constraints increase as the bank's capital ratio approaches the minimum capital requirement (CET1).

very controversial and, in this context, an appropriate public communication on the restrictions is needed. And after the impact of the pandemic becomes clearer, the additional capital preserved could be distributed to shareholders should it prove to have been unnecessary at that point.

III. POTENTIAL CONCERNS AND LIMITATIONS OF ADDITIONAL RESTRICTIONS

- Restrictions of capital distributions may raise concerns about the true size of losses arising from the COVID-19 pandemic. Currently, banks' capital levels are well above the regulatory minimum in numerous jurisdictions, which provide large buffers to absorb losses. Therefore, banks, market participants, or analysts could wonder whether regulators are increasing capital levels because they have information about losses that the market and banks are unaware of.
- Restrictions of capital distributions would have implications for shareholders, including institutional investors, for whom bank dividends may be an important source of income. Absence of investor clarity and uncertainty about the scope and duration of dividends restriction could affect banks' access to capital and raise the cost of capital. In particular, bank valuations might be depressed, making equity issuance more costly.
- Restrictions of capital distributions may raise legal issues in some jurisdictions, notably when banks are listed companies. Unless regulators have the legal authority under the legislation to restrict or suspend dividends, legal powers to set the dividends policy usually rest with the board of directors, subject to adequate disclosure policies. Should dividend policy be influenced or imposed by regulators, shareholders may consider legal actions against decisions to suspend or restrict dividends that do not have a sound legal basis.

The temporary nature of the suspension substantially mitigates some of these concerns. Furthermore, many of these challenges may be addressed through adequate supervisory communication and enhanced banks' disclosure, which would help reduce uncertainty and alleviate market concerns about the true size of losses. In certain jurisdictions, the lack of explicit legal powers over banks capital distribution might be a real impediment to the implementation of a policy limiting capital distributions even though supervisors can always resort to moral suasion. In that case, it is essential to give the right powers to supervisors, as further explained below.

IV. INSTRUMENTS AND APPROACH

Potential Mechanisms

Supervisors have a range of tools to ask banks to restrict or suspend capital distributions. These include announcing supervisory expectations or recommendations on suspending capital distribution, issuing more binding requirements on this issue, and using their general powers to ensure banks comply with the supervisory stance. The choice of these tools would depend on several factors, including the legal powers available to supervisors, the supervisory culture, and the interaction between banks and supervisors. Issuing a supervisory recommendation about the need for banks to limit their capital distribution is a robust tool to express supervisory preferences and stance. However, there is a risk that banks may not fully heed the supervisory recommendation and end up making discretionary capital distributions in the current crisis. In such cases, supervisors should consider the need for stronger interventions to reinforce their expectations. This could include using more general supervisory powers (including Pillar 2 (Supervisory Review Process) powers,[8] or those related to preserving financial stability) for banks that do not intend to comply with the recommendation.[9] In jurisdictions where such powers are lacking, supervisors may want to consider the best possible means to enforce their expectations, including the use of moral suasion and soft law powers.

To avoid the risks associated with an uneven implementation by banks, supervisors may choose to issue a more forceful decision from the outset, such as temporarily limiting capital distribution for all banks. This policy would send a strong signal to the market about the supervisory position and the need to ensure that banks' capital distributions are instead used to absorb potential losses and/or support lending to the economy. Such a policy could be facilitated if the legal framework explicitly provides extensive powers to the supervisor.

Banks that should be subject to the restrictions

The large and broad toll that the pandemic is taking on the economy suggests that all banks will face losses. Given the uncertainty of the size of the potential impact and considering potential contagion risks between banks, the recommended option would be to temporarily limit capital distributions across the entire banking sector. As mentioned earlier, applying this action to all banks would reduce the stigma and the potential market reaction if the measures were to be applied only to a subset of banks.

Some countries use stress tests to determine whether—and by how much—payouts should be restricted. These tests quantify the additional capital needed to keep banks resilient in the face of crisis, and are a vital guidepost helping to traverse an unfamiliar territory. However, the unique nature of the novel coronavirus outbreak shock and the uncertainty generated by the pandemic challenges the estimation of potential losses.

What Forms of Distribution Should Be Limited?

Various forms of capital distributions should be temporarily limited across the entire banking sector.[10] These include dividend payments and share buybacks, since the latter constitutes a significant portion of capital

[8] Pillar 2 (supervisory review process) is an integral part of the Basel framework. It aims at, among other things, giving the supervisors powers to assess banks' capital adequacy and to require banks to operate above minimum regulatory capital requirements. More details on Pillar 2 can be found at https://www.bis.org/basel_framework/standard/SRP.htm.

[9] For example, the Bank of England issued letters to banks warning that it was "ready to consider use of their supervisory powers" if they did not comply with its recommendations on suspending dividends, share buybacks, and cash bonuses to senior staff (see table below for more details).

[10] This policy should also apply to state-owned banks, which should be subject to the same prudential rules and requirements of private banks. In addition, taking such a measure vis-à-vis all banks, would ensure that banks could keep supporting the economy and that their capital resources are preserved, thus reducing the fiscal burden in case of any needed capital injection to absorb the impact of the crisis.

[11] The reasons that drive the strategic decision on dividend vs share buyback differ across banks and are based on several factors (for example, the current stock price, the bank's long-term vision, applicable tax rules, the message the

distributions in some banking systems (except for cases where share buyback decisions are not made for purposes other than capital distributions, for example, enforcement of claims under legal obligations or court rulings).[11] In addition, supervisory authorities should ask banks to limit all types of discretionary bonus payments. The restriction of capital distributions for all banks is vital given the uncertainty of the severity of the impact of the epidemic, potential contagion risks between banks, and market reaction, if bank does it alone.

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bank wants to give the stakeholders, and investment opportunities). Buybacks and dividends can significantly boost shareholder returns. Dividends provide a regular stream of cash flow and may be a big incentive for investors who rely heavily on their investments to meet their living expenses. Buybacks are a more tax-efficient way to return capital to shareholders because the investor does not incur any additional tax on the buyback sale process. Buybacks also reduce the number of outstanding shares, which can drive the share price higher over time.

Table 1. Observed Practices

Country	Restrictions Motivated by the Pandemic	Reference
Argentina	The Central Bank of the Argentina issued a statement indicating that the distribution of financial institutions results, including dividends and payouts, was suspended until June 30, 2020.	http://www.bcra.gob.ar/Noticias/Coronavirus-BCRa-medidas-directorio.asp
Australia	The Australian Prudential Regulation Authority (APRA) has written to all authorized deposit-taking institutions and insurers, outlining its expectations that these institutions limit discretionary capital distributions in the months ahead, including deferrals or prudent reductions in dividends.	https://www.apra.gov.au/news-and-publications/apra-issues-guidance-to-authorised-deposit-taking-institutions-and-insurers
Brazil	Authorities have issued regulations banning distribution of dividends, share buybacks and bonus until September 30, 2020.	https://www.bcb.gov.br/detalhenoticia/17033/nota.
EBA	The European Banking Authority (EBA) urged banks to follow prudent dividend and other distribution policies, including variable remuneration, and use capital for ensuring continuous financing to the economy. The EBA also emphasized that the capital relief resulting from the measures adopted by competent authorities in response to COVID-19 are to be used to finance the corporate and household sectors and not to increase the distribution of dividends or make share buybacks for the purpose of remunerating shareholders.	https://eba.europa.eu/eba-provides-additional-clarity-on-measures-mitigate-impact-covid-19-eu-banking-sector.
ECB and 19 supervisory authorities of eurozone countries	The European Central Bank (ECB) issued the recommendation to supervised significant credit institutions of eurozone countries: ● at least until October 1, 2020, no dividends are paid out and no irrevocable commitment to pay out dividends is undertaken by the credit institutions for the financial year 2019 and 2020; ● credit institutions refrain from share buy-backs aimed at remunerating shareholders; ● credit institutions that are unable to comply with this Recommendation because they legally required to pay out dividends should explain the reasons to ECB. The recommendation is also addressed to the national supervisory authorities (eurozone) with regard to less significant supervised entities.	https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200327~d4d8f81a53.en.html.
ESRB	The European Systemic Risk Board (ESRB) issued Recommendation on the System-Wide Restriction Of Distributions during the COVID-19 Pandemic**,** which supports and complements initiatives of the European Central Bank, the European Banking Authority, the European Insurance and Occupational Pensions Authority, and national authorities**.** The Recommendation covers banks, certain investment firms, insurers, reinsurers, and central counterparties. The ESRB recommended that at least until January 1, 2021, relevant authorities request financial institutions under their supervisory remit to refrain from undertaking any of the following actions: ● make a dividend distribution or give an irrevocable commitment to make a dividend distribution; ● buy-back ordinary shares; ● create an obligation to pay variable remuneration to a material risk taker.	https://www.esrb.europa.eu/news/pr/date/2020/html/esrb.pr200608~c9d71f035a.en.html
Georgia	The National Bank of Georgia issued the statement indicating that banks shall not use the relief on capital requirements for dividends, share buybacks, equity investments, increasing variable remuneration for management or other types of distributions and payments, which causes reduction of bank capital.	https://www.nbg.gov.ge/index.php?m=340&newsid=3901
Mexico	The Supervisory Authority (CNBV) issued a recommendation to banks to refrain from paying dividends or buying back shares or any other mechanism	https://www.banxico.org.mx/publicaciones-y-

	tending to reward shareholders with the aim of channeling resources to strengthen the banks' capital.	prensa/miscelaneos/%7BA88C7F3E-778D-E29A-E27B-98E739A7FA02%7D.pdf.
New Zealand	New Zealand Reserve Bank issued a statement that it was agreed with the banks that during COVID-19 outbreak there will be no payment of dividends on ordinary shares, and that they should not redeem non-CET1 capital instruments.	https://www.rbnz.govt.nz/news/2020/04/longer-term-funding-to-support-business-lending
Norway	In a letter to the Ministry of Finance (MoF), Finanstilsynet asked the Ministry to adopt regulations that require banks and insurance undertakings not to pay dividends (among others) for 2019 until further notice. While the MoF decided not to lay down such regulations now, it expressed a clear expectation that financial companies will wait for distribution of dividends given the uncertainties in the economic environment.	https://www.finanstilsynet.no/en/news-archive/press-releases/2020/finanstilsynet-proposes-regulations-on-retention-banks-insurance-undertakings-profits-2019-until-further-notice/
Russia	The Bank of Russia recommended that financial institutions hold annual general meetings to approve dividends for 2019 in late August–September 2020. It is further recommended that financial institutions that have already set the date for their annual general meetings before June 30, 2020, consider postponing it.	http://www.cbr.ru/eng/press/event/?id=6638#highlight=dividends
South Africa	The Prudential Authority (PA) issued a Guidance Note to all banks that it expects that no distribution of dividends on ordinary shares and no payment of cash bonuses to executive officers and material risk takers, should take place in 2020. The PA stated that capital resources must continue to be available to support the real economy and to absorb losses in the immediate and medium to long term.	https://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=9845
Sweden	The Supervisory Authority (FI) issued a statement that it expects banks not to issue dividends to shareholders until the widespread uncertainty surrounding the economy has stabilized.	https://www.fi.se/en/published/press-releases/2020/fi-expects-banks-and-credit-market-companies-to-stop-dividend-payments/
Switzerland	The Supervisory Authority (FINMA) issued a recommendation that financial institutions' distribution policy must be prudent, especially where relating to share buyback programs. FINMA publicly welcomed the announcement by UBS Group AG and Credit Suisse Group AG to postpone half of their planned dividend distributions for 2019 despite their position of capital strength.	https://www.finma.ch/en/news/2020/03/20200331-meldung-finma-aufsichtsmitteilung-02-2020/; https://www.finma.ch/en/news/2020/03/20200319-mm-corona/
United Kingdom	The Supervisory Authority (PRA) issued letters to the seven largest banks asking them: ● to cancel payments of any outstanding 2019 dividends; ● to consider suspending dividends and buybacks on ordinary shares until the end of 2020; ● not to pay any cash bonuses to senior staff, including all material risk takers, and take appropriate actions on accrual, payment, and vesting of variable remuneration over coming months; ● to confirm whether or not they are prepared to agree to this request and publish it. The PRA welcomed the decisions by the board of the large UK banks to suspend dividends and buybacks on ordinary shares until the end of 2020, and to cancel payments of any outstanding 2019 dividends in response to the request.	https://www.bankofengland.co.uk/prudential-regulation/letter/2020/letter-from-sam-woods-to-insurers-on-distribution-of-profits; https://www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-deposit-takers-approach-to-dividend-payments-share-buybacks-and-cash-bonuses
Ukraine	The National Bank of Ukraine recommended that banks refrain from directing their capital towards dividend payouts until economists are better	https://bank.gov.ua/news/all/natsionalniy-bank-vidterminuvav-

	able to estimate the fallout from the restrictions put in place to combat the coronavirus outbreak.	formuvannya-bankami-buferiv-kapitalu
United States	Supervisors assess capital distributions during the annual stress tests exercises. In light for the results of the stress tests for 2020 and additional sensitivity analyses conducted due to the coronavirus event, the Federal Reserve Board (FRB) has taken restrictive actions. For the third quarter of 2020, the FRB has required large banks to suspend share repurchases, capped dividend payments to the amount paid in the second quarter and further limited dividends according to a formula based on recent income. The FRB has also required banks to re-evaluate their longer-term capital plans.	https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm