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Sustainable Architecture for Finance in Europe (https://safe-frankfurt.de/)

SAFE Finance Blog

Let market forces work in the financial sector

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Jan Krahnen: The ban on dividend payouts by the Eurozone's supervisory authority is a discretionary action that clouds market expectations with regard to the equity of credit institutions

It was a rather unpleasant surprise for Europe's financial markets when the euro banking supervisory authority emphasized its demand for a ban on dividend payouts for credit institutions. The appeal of the ECB's Single Supervisory Mechanism (SSM) as a reaction to the economic consequences of the Corona crisis was valid from spring onwards initially until October. Meanwhile, the supervisors have communicated that the ban is to

continue until 1 January 2021. At first glance, such payout restrictions may appear compelling. A second glance, however, shows that these restrictions weaken market forces and thus question a fundamental conviction of Europe's banking union.

First of all and after the experiences of the financial crisis of 2008/2009 and the current economic uncertainty in Europe caused by the Corona crisis, the idea of the SSM to ban dividend payouts in order to keep the capital as a buffer at the banks is understandable. In particular, it should be avoided that the owners withdraw urgently needed funds from the banks and distribute them to the shareholders before the next shock, which is certainly not unlikely during the Corona crisis. The banks would lack fresh money precisely when they are most in need of it. This view is particularly widespread among critical bank observers and probably also finds support among the broader public.

However, there is a catch: as superficially positive as the short-term effect of banned dividends may be – more money available and broad approval among the population – it can, however, become profoundly negative in the longer term. Why?

Contract compliance as a decisive element for financial markets

The problem with discretionary policy actions such as the imposed ban on dividend payouts is that they fundamentally change market expectations with regard to the equity of banks and insurers in the long term and thus under circumstances also reduce or completely prevent investments in the European financial markets. The ban on dividend payouts under the SSM may even lead to higher distributions later on for fear of recurrence and thus counteract the actual intention of the supervisory authority which is to strengthen the equity base of credit institutions.

In other words: Equity, which is exposed to the risk of finding itself one day in a kind of mousetrap, is valued less on the market, the capital costs of the affected companies rise, and the possibility of finding new equity providers in the future deteriorates. In particular, it is then as good as impossible to take up new own capital funds in a crisis situation. Moreover, a sudden infringement of the shareholders' right of dividend payments not only violates the original contractual basis on the capital market but also sows doubts about which further rules could be changed unilaterally afterwards if it only receives applause from politicians and the public.

Pact sunt servanda – contract compliance is a decisive element for the functioning of financial markets. Anyone who breaches contract compliance not only breaches private international law but also boosts competing financial centers. This comes at the expense of the domestic financial center, of course, which cannot be intended by politics. Therefore, a warning must be issued against any form of a one-sided payout stop, which will be expensive to pay later on if the ruined reputation among international investors and pension funds from all over the world has to be rebuilt over many years.

Strengthening SRB as an alternative to the ban on dividend payouts

The more important signal from the SSM to the markets would be to adhere to initially predetermined regulatory structures in such a way that the existing possibilities offered by the EU Bank Recovery and Resolution Directive allow for consolidation, especially of the banking sector. If the situation is clear from the very beginning and discretionary infringement in ownership is avoided, especially in times of crisis, in favor of legal certainty and contract compliance there is no general suspicion that new rules will be set up at will in the future.

The argument of legal certainty and contract compliance is a classic regulatory concept for avoiding infringements on property rights. This idea can be implemented very well at the European level where it then offers an alternative to the ban on dividend payouts for shareholders by strengthening the Banking Union’s Single Resolution Board. Strict compliance with the SRB rules would oblige banks to maintain the good quality of their investors' holdings and thus, in an emergency, also of their creditors. First, this would feed into the equity base of European banks, which has been notoriously thin for years. Second, a regulatory structure would be put in place that would allow the banking sector to shrink sensibly where it is needed. This structure also promises long-term sustainability.

Market exits as a progress and not necessarily a danger

The reason given by the supervisory authority for the ban on dividend payouts further overlooks the fact that an excessive dividend policy increases the financing costs for so-called bail-in capital, i.e. subordinated debt, and

therefore an excessive dividend payment directly increases the bank's financing costs. This holds true, of course, for the assumption that banks must hold more such subordinated capital today than ever before. The net benefit of a dividend payout is then small or non-existent.

Finally, there is the side-effect of possible bank exit. This side-effect can only be welcomed by critics of the low-profit European banking system: In a sector that already suffers from overbanking market exits are a relief since they represent progress and not necessarily a danger.

Particularly sealing off the banking sector at the national level with state aid contradicts the experience from previous crises and ultimately also the core European idea. In other sectors, such as mechanical engineering and automotive engineering, we have long since left national isolationism behind us. In short, the ban on dividend payouts as stipulated by the SSM can be damaging in the long term. The market, its rules, and mechanisms should not be changed without necessity even if it seems appropriate in times of crisis.

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