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Only recapitalised banks should pay dividends

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From Prof Anat R. Admati and others.

Sir, William Isaac (“Banks should be allowed to pay out dividends”, Comment, February 9) supports higher capital requirements, but argues that preventing profitable banks from paying “reasonable” dividends impedes bank lending and economic growth. We disagree.

Paying dividends immediately reduces bank capital and the amount of money available to lend. Mr Isaac claims that if banks do not pay dividends now, they will have trouble raising capital later. But to raise capital it is not necessary that a company has paid dividends in its recent history. For example, a year after it went public, Google raised more than \$2bn of new equity, even though it had not paid any dividends.

A dollar paid out to shareholders through either dividends or share repurchases is a dollar that would not be accessible to creditors in a situation of financial distress. For this reason, and to prevent the shifting of value from debt holders to equity holders, debt covenants typically restrict dividend payments when leverage is high. Debt covenants may be less restrictive in banking because most bank creditors are explicitly or implicitly insured, and thus are less concerned with dividend payments that reduce their security.

But taxpayers should be concerned when banks pay dividends and remain thinly capitalised, because, as we have seen, taxpayers are the ones who are likely to end up covering the banks’ liabilities in a crisis. Moreover, everyone suffers from the consequences of the greater systemic risk associated with highly leveraged banks.

Mr Isaac suggests that the fastest way to meet capital requirements is for banks to raise significant amounts in new equity. We strongly support recapitalisation with new equity. However, the US banks that want to pay dividends have not announced plans to raise new equity, and regulators are not forcing them to do so. Moreover, retaining earnings is generally viewed as the least costly way to

raise funds and build capital, as it avoids the transactions costs associated with new equity issuance.

The fact remains that if banks retain earnings rather than pay them out, there is less need or urgency for them to raise new capital. With more retained earnings, banks would have more funds immediately available to lend, which would promote growth. Once banks are safely capitalised, which would require them to have significantly more equity on their balance sheets than they currently have, paying dividends would be appropriate.

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