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Why the bank dividends are a bad idea

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[1] On the basis of “stress tests” it ran, the Federal Reserve has [given permission to most of the largest U.S. banks to “return capital”](#) [2] to their shareholders. JPMorgan Chase announced that it would buy back as much as \$15 billion of its stock and raise its quarterly dividend to 30 cents a share, up from 25 cents a share.

Allowing the payouts to equity is misguided. It exposes the economy to unnecessary risks without valid justification.

Money paid to shareholders (or managers) is no longer available to pay creditors. Share buybacks and dividend payments reduce the banks’ ability to absorb losses without becoming distressed. When a large “systemic” bank is distressed, the ripple effects are felt throughout the economy. We may all feel the consequences.

Most European banks passed stress tests in July 2011, only to find themselves near failure, including one major bank, Dexia, which was nationalized shortly thereafter. Even if U.S. stress tests are better, are American banks healthy and immune? Is it prudent to allow them to make payouts to shareholders? Before 2008, banks convinced

regulators that they were safe on the basis of insurance they bought from AIG. Banks avoided billions in losses when AIG was bailed out. Assets considered “safe” by regulators routinely turn out to inflict losses. We often discover hidden risks when it is too late.

Among the most obvious mistakes made in 2007-2008 was allowing banks to deplete their ability to withstand losses. The largest 19 U.S. banks paid almost \$80 billion to shareholders between the third quarter of 2007, when trouble in the housing market was looming, and through the worst of the financial crisis in 2008. About half of the money the government invested in banks during the crisis, when credit markets froze, was paid out to shareholders and not used for lending or to pay creditors.

Dividends and share buybacks for large banks resumed in spring 2011. The largest [U.S. banks paid \\$33 billion in the first nine months of 2011](#) [3]. When JPMorgan Chase paid almost \$1 billion in dividends in November 2011, out of more than \$11 billion it paid out in the last year, its debt were at \$2.1 trillion, while its entire equity was worth less than \$110 billion, about 5 percent of the debt. The creditors of any normal company would have not allowed shareholders to take out cash under such conditions. For banks, taxpayers must worry, because taxpayers bear the consequences of serious losses.

If a strong bank retains its earnings and invests prudently, shareholders are still entitled to the profits from these investments, as long as debts are paid. Many successful companies do not pay dividends for extended periods of time, and their stock prices reflect their good investments. When banks distribute profits to shareholders and continue to borrow, they create more risk. This pollutes the interconnected financial system by increasing its fragility. If banks do not want to invest the profits, they can use them to pay down some of their debts.

Jamie Dimon, the outspoken CEO of JPMorgan Chase, rails relentlessly against requirements that banks use more equity. He and others make self-interested and empty threats claiming that such requirements would harm the economy. The use of more equity or, as bankers call it

“capital,” does not require that banks “set aside” any funds, and it does not prevent them from lending. It does not even increase their costs in any relevant way. The main effect, and the main reason bankers fight this, is that more downside risks are borne by those who benefit from the upside, rather than by creditors or taxpayers.

Dimon said in March 2011 that higher capital requirements in the U.S. would be [“a nail in the coffin of big American banks.”](#) [4] He later called Basel III, the international accord on capital requirement, [“anti-American.”](#) [5] Dimon falsely equates what is good for American bankers and what is good for America. It is not a national priority that our banks be globally successful if this endangers the rest of us. “Successful” banks in Ireland and Iceland ruined their economies.

Prominent academics have warned for more than a year that [Basel III is insufficient and flawed](#) [6]. The U.S. should lead the world in prudent regulation by setting higher, and better-designed, requirements than the minimum set by Basel III, and call to re-examine the accord. This is not what Jamie Dimon wants, but it would be the “pro-American” thing to do. Until the costs and benefits of different capital requirements are fully studied, and independent of stress test results, it is imprudent to allow large banks to deplete their loss-absorbing equity. If done for the safety of the system and across the board, there will be no stigma associated with delaying dividends. There is simply no benefit and no urgency to justify allowing JPMorgan Chase to pay more than \$15 billion to its shareholders (who include Mr. Dimon) in the next year. Mr. Dimon can surely find something prudent to do with the funds.

Some are concerned that tough regulation would cause banking activity to move to unregulated shadows. Effective enforcement is essential for any regulation to achieve its goals. Lax enforcement of prior regulation enabled banks to hide their true risks and helped usher in the previous crisis. Just as we try to close tax loopholes, we must tackle the enforcement challenge of financial regulation or suffer the consequences of not doing so.

Concerns that there is “not enough equity” for banks are also misplaced. Equity can be built by retaining profits and not paying them out to shareholders. Banks also have access to stock markets where they can raise more equity. Like stocks of other companies, bank stocks are valued based on their risk-and-return prospects. Viable banks that generate shareholder value can sell their shares at appropriate prices.

Bankers have become addicted to borrowing. They are not in a position to tell us what the economy needs. Their excessive borrowing works for them, but not for the rest of us. The public, including diversified bank shareholders, suffers from the risks that a fragile system imposes on the economy. Regulators must stand up to bank lobbying and focus on ensuring financial stability in a cost-effective way. When regulators fail, we all pay the price.

PHOTO: James Dimon, CEO of JPMorgan Chase, arrives at a business forum of the German daily Die Welt in Berlin, January 11, 2012. REUTERS/Thomas Peter

[1] Image: <http://blogs.reuters.com/great-debate/files/2012/03/dimon.jpg>

[2] given permission to most of the largest U.S. banks to “return capital”:

<http://www.reuters.com/article/2012/03/14/us-usa-banks-stresstests-idUSBRE82C19020120314>

[3] U.S. banks paid \$33 billion in the first nine months of 2011:

<http://www.propublica.org/article/fed-shrugged-off-warning-let-banks-pay-shareholders-billions>

[4] “a nail in the coffin of big American banks.”: <http://www.ft.com/intl/cms/s/0/3157bcbe-5b05-11e0-a290-00144feab49a.html%20or%20%20http://www.cnbc.com/id/42352915>

[5] “anti-American.”: <http://www.ft.com/intl/cms/s/0/905aeb88-dc50-11e0-865400144feabdc0.html#axzz1ov7BP5wC>

[6] Basel III is insufficient and flawed:

<http://gsb.stanford.edu/news/research/admatiopen.html>

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