RESTORING THE BALANCE SHEETS OF LARGE AND COMPLEX BANKING GROUPS IN THE EURO AREA: DIVIDEND CUTS AND ASSET DISPOSALS

The losses suffered by euro area LCBGs as a result of the financial turmoil have forced many of them to contain risks by reducing the leverage on their balance sheets. When doing so, banks can follow three different options (or any combination thereof). They can raise new capital, they can reduce their dividend pay-out ratios, or they can shed assets. This box focuses on the latter two channels of deleveraging, i.e. on dividend policies and asset disposals. In so doing it provides some estimates of the potential impact on leverage should euro area LCBGs choose one of these options, rather than raising new equity capital, to restore their balance sheets.

Regarding dividend policies, banks typically keep dividend payment levels steady in order to meet investors’ expectations of stable dividend flows and to avoid negative signalling effects. So far this year, there have been only a few announcements of banks’ cutting dividends, and even these were mostly by banks located outside the euro area. By contrast, some euro area LCBGs have even continued to increase their dividend payments. Moreover, some banks funded dividend payouts with dilutive share offerings or other expensive forms of equity financing, such as higher-yielding preference shares. In the face of an eroding capital base, such policies do not appear to be sustainable. For a group of 14 euro area LCBGs, dividend payouts amounted to €31 billion in 2007, while their additions to reserves in the form of retained earnings were €39 billion. This compares with €45 billion of capital that they raised by September this year.

Most euro area LCBGs maintained a dividend payout ratio of around 45% over the last few years (see Chart A). Notably, however, banks that were hardest hit by the financial turbulence in 2001-02 kept up their dividend payment levels while their earnings eroded, leading to a substantial increase in the payout ratios in those years.

Looking forward, given the difficulties encountered by many LCBGs in raising capital from private sources, dividend cuts may be a viable alternative to strengthen capital bases. A computation using data from 2007 shows that a total suspension of dividend payments – an extreme scenario – would have increased euro area LCBGs’ Tier 1 capital ratios by 64 basis

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**Chart A** Dispersion in dividend pay-out ratios for euro area large and complex banking groups

(percentage; maximum, minimum, interquartile distribution and median)

Sources: Bloomberg and ECB calculations.

Note: The sample consists of 14 euro area LCBGs. Dividend payout ratios larger than 100% indicate that LCBGs drew on reserves to pay out dividends in excess of current earnings.
points in 2008, from 7.54% to 8.17% (see Chart B). Using earnings data for the first half of 2008, a similar dividend payout policy could have boosted Tier 1 capital ratios by up to 50 basis points, from 7.90% to 8.40%.

It must be borne in mind in this context that current dividend yields have reached historical peaks, given the dramatic decline in bank stock prices over the past few months. Therefore, a reduction of dividends to levels that ensure a long-term average dividend yield of about 3-4% could be seen as a reasonable measure. Moreover, some banks may also be forced to cut dividends in order to fulfill requirements of certain government rescue plans or if their capital ratios fall below a certain predefined level. In the long run, dividend cuts might even contribute to avoiding the need for state recapitalisation and could help banks in retaining their independence.

As regards deleveraging by means of asset disposals, assuming that LCBGs aim at reducing their leverage ratios from the current elevated levels, it is possible to calculate the extent of balance sheet shrinkage that would be required to restore the balance sheets without raising additional capital or cutting dividends.1 Chart C shows the distribution of the estimated scope for deleveraging for individual euro area LCBGs, both as a share of these institutions’ total assets and as a share of their customer loans, after accounting for the capital already raised by some institutions. Two alternative cases are considered. In the first case, LCBGs would bring their leverage multiples back to the levels that prevailed prior to the turmoil (the average multiple, defined as risk-weighted assets divided by total capital, for the euro area LCBGs was 8.95 in mid-2007). In the second case, they would converge on a uniform multiple of 7.5 applied to all institutions.2

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1 For details of the estimation, see Greenlaw, Hatzius, Kashyap and Shin, “Leveraged Losses: Lessons from the Mortgage Market Meltdown”, paper presented at the US Monetary Policy Forum Conference, 2008. The authors estimate that, with the information available at the end of February 2008, the potential deleveraging in the entire US financial sector would have amounted to just under USD 2 trillion.

2 Note that leverage multiple is defined here as the inverse of the total capital ratio. Therefore, the leverage multiples quoted in the text would correspond to total capital ratios of 11.1% and 13.3% respectively.
All other things being equal, in order to reach the pre-turmoil level of its leverage multiple, the median LCBG would have to reduce its balance sheet by an amount that corresponds to 3.1% of its total assets, or by 8.9% of its total customer loans.

Measured in euro, the total LCBG deleveraging would amount to around €540 billion in this case. To reach the 7.5 leverage multiple, the amount of deleveraging by the median institution would have to be 11.8% of total assets, or 27.9% of customer loans. These figures are large and, should they crystallise, would imply a significant contraction of credit to the private sector.

All in all, as many banks may be reluctant to excessively reduce their dividend payouts or to aggressively shed assets in the current difficult market conditions, there is a strong case for euro area LCBGs to raise new equity capital as a complementary means of reducing leverage in their balance sheets. When equity capital cannot be raised from private sources at a reasonable cost, banks in the euro area should take full advantage of the resources that were made available by various governments in the fourth quarter of 2008.