

Dividend policies in the Spanish banking sector

Miguel Arregui and Ángel Berges¹

The severe impact of the crisis on Spain and its financial sector led to a notable increase in corporate dividend payout ratios, with the greatest effort made by banks. Innovative dividend policies allowed banks to achieve the dual objective of maintaining stable dividends, while boosting capital ratios, but traditional cash payment should re-emerge as the main form of dividend remuneration post crisis.

Generally speaking, listed companies go to great lengths to keep their dividends stable. Against the backdrop of earnings contraction, this stability is achieved at the cost of higher payout ratios. The IBEX is one of the stock indices most sensitive to dividend variability, as its dividend yield is higher than that of comparable indices. The same can be said of the Spanish banks, which during the crisis years saw their payout ratios rise above 100%, covered largely in the form of scrip dividends. This payment formula enabled Spanish banks to maintain high dividend yields, while increasing capital, in sharp contrast to what would have happened if they had paid these dividends in cash.

Dividend policy: Some considerations

The dividend payment policy of listed companies has been one of the issues most intensely debated in both academic and empirical financial papers. In contrast to the traditional academic theories regarding the financial irrelevance of paying or not paying dividends, empirical observations reveal that dividend policy does affect share price performance, and significantly so.

This is evident in the stability that most companies try to imprint on their dividend policies, preventing wide swings and trying to keep their dividends constant or growing moderately over time, but trying at all costs to avoid cutting them. The search for a stable dividend in monetary terms translates

into a markedly pro-cyclical trend in the payout ratio, *i.e.*, the percentage of the companies' profits that is paid out to its shareholders. In fact, certain listed companies' payout ratios have peaked at over 100% at times of sharp earnings compression, as was the case at the height of the last crisis.

Listed companies try to maintain a stable dividend policy. This is particularly true of listed banks.

Additional evidence points to variability in dividend remuneration by sector. By way of example, high-

¹ A.F.I. - Analistas Financieros Internacionales, S.A.

growth sectors or companies tend to pursue more austere dividend policies. On the other hand, mature companies or those faced with reduced growth prospects are typically far more generous with their dividend payments.

In the specific case of banks, another factor comes into play related to their regulated nature (regulations may impose restrictions on dividend payments and/or the need to reinforce capital). Furthermore, the perception that dividend payments are a sign of an entity's financial health is yet another factor that has historically driven banks to keep their dividends stable or even increase them. This symbolic message value, by virtue of which a dividend cut could be interpreted as a sign of financial weakness, is important for all kinds of companies; however, it is particularly important in the case of banks. An adverse message may impact not only their shareholders, but also their creditors and depositors, thereby affecting not only capital, but also other assets and liabilities.

In light of these considerations regarding the importance of corporate dividend policy,

above all in the case of banks, we have analysed dividend policy at financial institutions compared to the rest of the listed companies in Spain. We pay special attention to the trends in policy before, during and after the crisis, which has affected all listed companies, but has had a more devastating effect on credit institutions.

An area of particular significance within this comparative analysis is the role played by scrip dividends (dividends paid in shares instead of cash), which have grown enormously in importance in recent years. Again, this is particularly true in the case of banks, as scrip dividends allow for remunerating shareholders while at the same time reinforcing capital.

Dividends on the Spanish stock exchange: An international comparison

From the standpoint of an equities investor, the two main sources of returns are the share price performance and the yield obtained via dividends.

Table 1

Shareholder remuneration in Spain

Dividends and other payments made by listed companies. Pre-tax amounts (millions of euros)

	Dividends	Distribution of share premium reserve	Return of shareholder contributions (nominal capital)	Total
2005	14,436	4,464	224	19,123
2006	21,810	513	761	23,084
2007	23,339	220	-	23,559
2008	28,065	347	-	28,412
2009	33,115	763	4	33,882
2010	24,288	295	9	24,593
2011	28,213	5,433	14	33,659
2012	26,769	384	-	27,153
2013	23,263	133	19	23,414
2014	43,261	146	3	43,409

Note: Since 2009, the dividend figure includes the total amount paid out using the scrip dividend formula and that collected by shareholders by selling their pre-emptive subscription rights to the company or on the market (cash) plus the equivalent monetary value of the bonus share rights exercised (shares).

Source: Bolsas y Mercados Españoles (BME).

As already noted, classical academic theory holds that in the absence of differing tax treatments of dividend payments versus reinvestment thereof, investors should be indifferent as to whether or not they receive dividends.

Dividends have been the main source of return for Spanish equity investors during the crisis years.

Nevertheless, listed companies are curiously committed to their dividend payments. This commitment is all the more noteworthy in the case of the Spanish stock exchange, which offers a higher percentage of shareholder remuneration in the form of dividends versus capital gains than many global stock exchanges.

In 2014, according to *Bolsas y Mercados Españoles* (BME), Spain's listed companies paid out 43 billion euros in dividends, some 85% more than in 2013 (although the 2014 figure is

somewhat distorted by a special dividend payment totalling 14.5 billion euros made by Endesa in the wake of a major disposal effort). Apart from that special dividend, Spain's listed companies paid out around 28 billion euros, marking year-on-year growth of 20%.

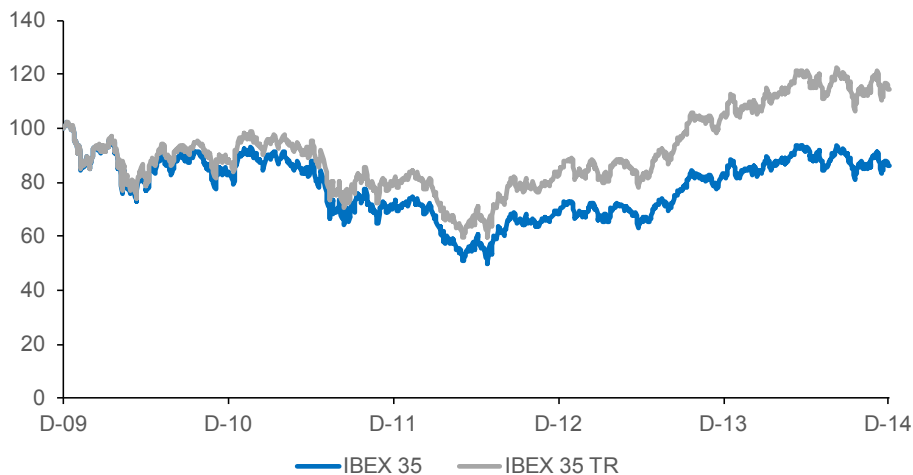
The dividend yield, expressed as a percentage of market value, was just over 5% (3.4% excluding the special Endesa dividend). Either way, this constitutes one of the highest dividend yields among the leading global stock exchanges.

The importance of dividends relative to other source of shareholder remuneration, share price gains, is evident in Exhibit 1 below. It reveals a negative cumulate return excluding dividends (*i.e.*, only reflecting share price performance) for IBEX 35 investors during the last five years of 10%. Factoring in dividends, however, the return jumps to a positive 20%.

Dividends emerged, therefore, as the main source of shareholder remuneration for Spanish equity investors during the crisis years, this phenomenon

Exhibit 1

Trend in the IBEX 35 vs. the IBEX 35 including gross dividends
(rebased to 100 as of Dec. 31st, 2009)*



Note: *TR: total return, *i.e.* including dividends before withholding tax.

Source: Bloomberg.

presenting a double interpretation. On the one hand, it reflects management concern towards shareholders, attempting to preserve their capital against the backdrop of generally depressed asset valuations. However, it may also be read as a lack of organic growth opportunities.

Dividends and profits: 100% Payout

The above observation leads us to another interesting reflection on the link between dividends and corporate earnings, as measured by the payout concept alluded to earlier.

Throughout the crisis, Spanish banks paid out more in dividends than they generated in net profits.

Such dividend stability throughout a period of marked earnings volatility unquestionably implies a significant pro-cyclical bias to the payout ratio, something we analyse next. Firstly, comparing the IBEX with the Eurostoxx, and secondly, comparing banks with non-financial corporates traded on the IBEX.

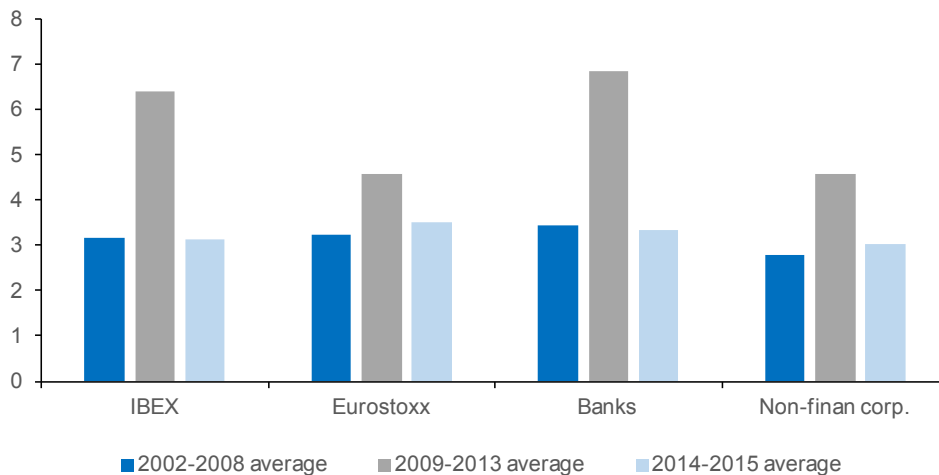
In the pre-crisis years (we take 2004 - 2008 as the reference period), against the backdrop of sharp economic growth, the IBEX was paying out an average dividend of close to 3%, with little difference between banks and non-financial corporates.

The 'effort' made to undertake this payment, measured using the payout ratio (dividend divided by net profit), was reasonably reduced. The IBEX components were paying out a little under 50% of net profit. The non-financial corporates were stretching themselves even less, paying out barely 40% of net profit. In contrast, banks were earmarking a higher percentage of their net profits to dividend payments, presenting payout ratios of close to 55%.

Between 2007 and 2014, and excluding the impact of the Endesa dividend, overall payments moved in a tight range between 23 and 28 billion euros.

Exhibit 2

Comparative dividend yields (percentage of share price)

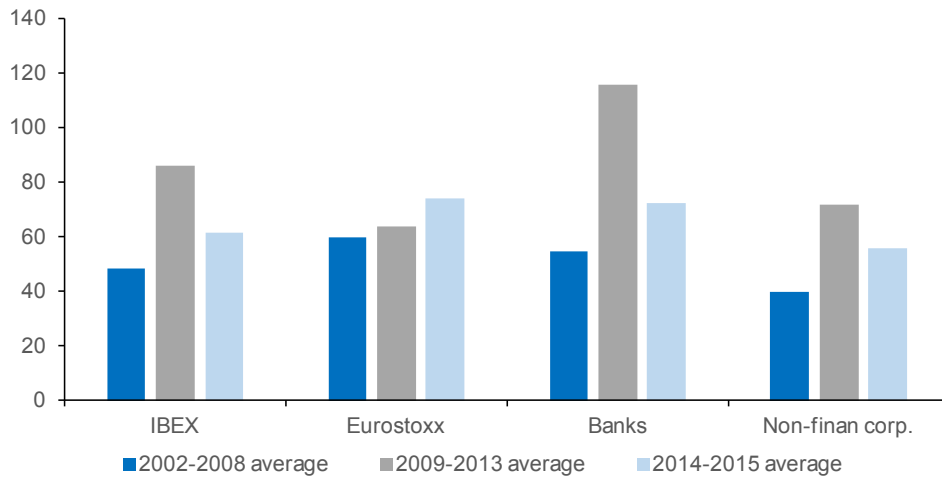


Source: AFI, based on Bloomberg figures.

Exhibit 3

Payout

(dividends over net profit, percentage)



Source: AFI, based on Bloomberg figures.

The situation changed radically between 2009 and 2013, particularly in the banking sector. From their stock market highs to their lows, listed Spanish banks saw almost 50% of their market value, around 100 billion euros, wiped out. Their net profits fell by similar percentages.

Both the EuroStoxx and the IBEX, and within the latter, banks and non-financial corporates, increased their payouts. Against the backdrop of profit contraction, a sharp economic slowdown and heightened risk aversion, listed companies had to make a bigger effort to maintain their dividend remuneration.

In the case of the EuroStoxx companies, the payout rose to 65%, some 20 percentage points below that of the IBEX. The reasons the IBEX had to make a bigger effort were two-fold. On the one hand, the crisis hit Spain harder, so that net profits contracted by more than in other countries. Secondly, because the relative weight of the banking sector, which was particularly hard hit, is higher in the case of the IBEX than other stock exchanges.

Banks' payout ratios during the crisis years topped 100%. This means banks were earmarking more resources to dividends than they were generating in profits during the year, which was hardly surprising given the fact that banks lost money for several years in a row.

Scrip dividends in the banking sector

In addition to earmarking more to dividends than the net profit generated, banks innovatively resurrected another mechanism: the payment of dividends in shares, known as a scrip dividend scheme.

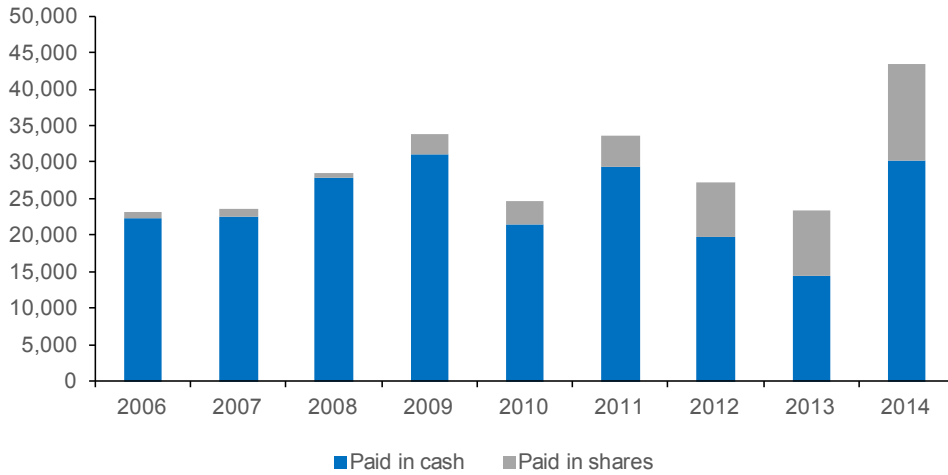
The scrip dividend has emerged as a common form of dividend payment.

Although this payment formula is not new, it was not until 2009 that its use became widespread, peaking in 2014. Scrip dividends amounted to 13 billion euros in 2014, which is equivalent to 30% of

Exhibit 4

Shareholder remuneration in Spain

Payment in cash and shares in millions of euros*



Note: *Share-based payments include scrip dividends and payments charged against share premium reserves.

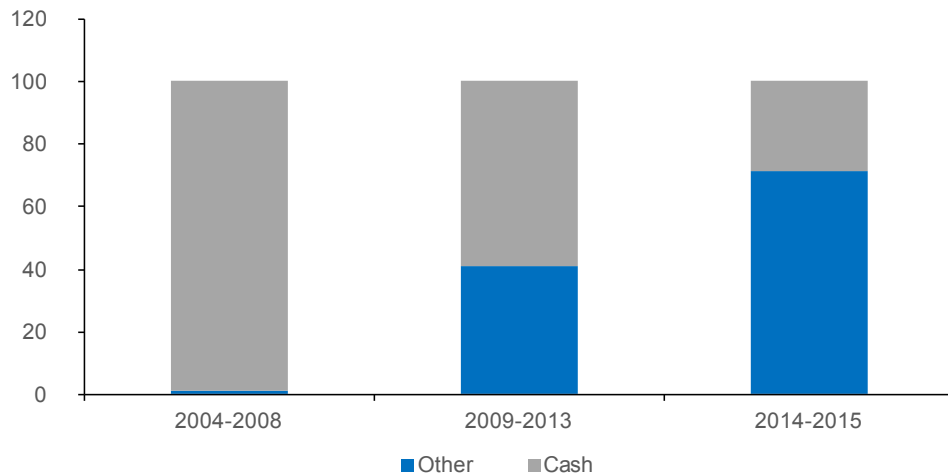
Source: Bolsas y Mercados Españoles (BME).

all dividends paid out by listed Spanish companies that year. If we strip out the special dividend paid by Endesa, this figure rises to 50%.

Around one dozen companies paid dividends using the scrip formula in 2014. Of these, banks embraced the scheme most whole-heartedly. Of

Exhibit 5

Form of dividends paid by IBEX-traded banks (percentage of total)



Sources: AFI, based on data obtained from the CNMV, banks and Bloomberg.

the 13 billion euros paid out in the form of shares by listed Spanish companies, 9 billion euros was distributed by banks. Indeed, the scrip dividend formula has overwhelmingly dominated cash dividends in the case of banks in recent years.

Against the backdrop of deleveraging, earnings contraction, risk aversion and growing capital requirements, Spanish banks opted *en masse* to pay their dividends in the form of shares. This enabled them to maintain high dividend yields, while increasing capital, in sharp contrast to what would have happened if they had paid these dividends in cash.

In tandem, the scrip formula was boosted by the Bank of Spain's recommendation, urging banks to limit shareholder remuneration, specifically recommending that cash dividends not exceed 25% of profit for the year. The effort to recapitalise and clean up banks' balance sheets helped, at the aggregate level, to drive a recovery in their market values to pre-crisis levels (market value recovery but not full share price recovery), as well as liquidity gains.

Conclusions

Without detracting from the importance of scrip dividends for Spanish banks in recent years, we believe cash dividends will gradually re-emerge as the main form of dividend remuneration. In fact, several of the leading listed Spanish banks have already announced plans to abandon their scrip dividends and reinstate cash dividends as their main form of remuneration.

The scrip dividend proved a very effective vehicle at a time of heightened market uncertainty, allowing banks to meet a dual objective: (i) fuelling shareholders' 'expectation' of generous remuneration, largely immune to earnings contraction; and (ii) reinforcing banks' capital by means of the shares delivered in the form of dividends. In essence, the scrip dividend formula was tantamount to a concealed rights issue, which was especially well-suited at a time when

the markets were not ready to absorb major equity placements. They were still digesting the largest financial and stock market crisis in a very long time.

However, with market conditions largely normalised, we believe that these masked rights issues will give way to a far more transparent capital management policy. Such transparency would translate into the payment of dividends in cash and, in parallel, should a bank need to reinforce its capital, the upfront presentation of a rights issue, with shareholders free to decide whether or not to participate, *i.e.*, decoupling the two decisions (dividend payment versus rights issue).