Bank Dividend Cuts:
Recent Experience and the Traditional View

By Howard Keen, Jr.*

Slashing the dividend on common stock may be considered all right for firms in some industries, but when it comes to banking, it's been a different story. From the 1930s until very recently, dividend cuts were all but unthinkable for commercial bankers. The traditional view was that no banker would cut dividends unless his bank were in a severe earnings or liquidity crunch and that such a move would have a chilling effect on the bank's health.

In the past few years, however, several large banking firms have taken the plunge—with less than disastrous results. Share prices have fallen, but deposits have held up surprisingly well. All the evidence isn't in yet, but it appears that for some banks, under some circumstances, where other options seem to be closed off, a dividend cut may be taken without producing the catastrophic results that bankers traditionally have feared.

DIVIDENDS IN BANKING
One of the important tasks a banker faces is that of choosing the right dividend policy for his bank. How he decides to split his bank's income between cash dividends and retained earnings can affect the cost of his equity capital and the wealth of his bank's shareholders. (In this article, 'bank' is used for both banks and bank holding companies.)

A banker has to resolve two basic issues about dividends. First, the dividend payout ratio—the average ratio of cash dividends to after-tax earnings over the long term—must be chosen. What payout ratio is best will depend on the earning opportunities of the

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DIVIDENDS AND RETAINED EARNINGS

Like their counterparts in other industries, bankers try to build up the value of their firms. Typically, a firm's value is measured by the share price of its common stock. And this share price can be influenced by the payout ratio—the average ratio of dividends to after-tax earnings—which is determined when bankers decide how much of their earnings to pay in cash dividends and how much to retain.

Earnings are paid out in dividends or are retained, and the decision to retain earnings makes a difference to shareholders because it can affect the return they make on their investments. Retained earnings are put back to work for shareholders by the bank. If the bank has better earning opportunities for these funds than are available elsewhere, a higher level of retained earnings will boost shareholder returns. If the bank's earning opportunities are not as good, shareholders will do better with more cash dividends. When earning opportunities are equal, other considerations may sway investors toward either retained earnings or cash dividends.

Retained earnings provide a relatively inexpensive source of equity capital because they permit banks to avoid the flotation costs associated with new issues of common stock. Thus using earnings instead of other sources of funds can increase bank profitability, share prices, and returns to investors.

Also, current tax laws encourage investors to favor retained earnings. Dividends, except for the first hundred dollars, are taxed at a relatively high rate as ordinary income, while increases in share prices are taxed as capital gains at a lower rate.

Most investors may prefer to take their earnings in cash dividends, however, because dividends are easier to spend than increases in the value of common stock. While any part of a cash dividend can be spent, a capital gain can be spent only if shares of stock are sold. The investor who sells shares will incur transaction costs and may have to sell a share worth many times the amount of money he wants to spend.

Choosing the most favorable payout ratio is no easy task. Current dividends may well be important to investors in bank stocks. Yet every dollar paid out in dividends could have been retained. Thus, bankers face a challenge in their efforts to use earnings as equity capital and to do it in such a way that the price of their banks' shares won't suffer.
The aggregate payout ratio of commercial banks has been trending downward over the past 15 years. This is not, however, because of reductions in cash dividends. While dividends have not increased as fast as earnings, they have followed a steady upward path. Apparently, the arguments in favor of dividend stability carry some weight with bankers. Moreover, one of the arguments—the one about the information provided by a change in dividends—seems to be at the heart of the traditional view on dividend cuts. The message that comes through loud and clear from that view is, “Avoid a dividend cut.”

**TRADITIONAL VIEW OF DIVIDEND CUTS**

This view was evident in responses by financial experts to a 1975 survey question concerning what would happen if a major money center bank were to cut its dividend. The responses had an overwhelming air of crisis and doom about them. One respondent noted that the reason for the cut would be of prime importance, but virtually all seemed to assume that a cut would occur only under severe earnings or liquidity pressures.

The traditional view of bank dividend cuts has perhaps been best summarized by Paul Nadler: “Dividend cuts are drastic and are undertaken only when a bank has no alternative. A bank that cuts its dividend is giving a signal to the entire financial community that it has trouble that will not go away soon. The result is that individual depositors start shying away from that bank, if finds it hard to sell certificates of deposit to corporate or municipal investors, and generally the bank’s entire posture suffers.”

**Why the Fear of Cuts?** Several reasons have been advanced for the strong fear of dividend cuts by banks. First, current dividends are deemed to be important to investors in bank stocks. This may be because investors tend to count on dividend income as a source of spending on a regular basis. A dividend cut, when it represents a break from past practice, can be disconcerting to current shareholders and might lead prospective shareholders to lower their evaluations of the bank’s stock.

Second, cutting dividends may be interpreted as a sign that the bank is in much worse shape than it actually is. According to one writer, “Forgoing or even reducing a dividend is generally interpreted as an indication that a bank is in serious financial difficulty.” And another remarks, “Cutting dividends has a negative connotation with investors and reflects a pessimistic view of the future by management.”

If a dividend cut is taken as an indication that the cutting bank has a bleaker future than it was thought to have, potential investors may offer less for its shares than they did before. And the reduction in share price that follows will reduce the wealth of current shareholders. Part of their wealth consists in the market value of their holdings of stock, and if the share prices of their bank stocks fall, that portion of their wealth will be reduced.

Finally, other suppliers of funds may view the bank as being riskier. Those suppliers might include buyers of the bank’s debt securities and buyers of CDs in denominations that are not covered by deposit insurance.

The upshot of all of this is the possibility of...
a greatly increased cost of funds to the bank. And every banker knows what that can mean to the bottom line of the income statement. Thus it’s easy to understand the concern bankers have over the issue of dividend cuts.

AN UNCOMMON OCCURRENCE: A HOST OF DIVIDEND CUTS

For about forty years after the Depression, so far as the records show, bank dividend cuts were relatively infrequent. The picture began to change, however, when Central National Chicago Corporation announced on December 18, 1974 that it was cutting its quarterly dividend from 30 cents to 15 cents a share. And since the Central National Chicago cut, there has been a good deal of dividend-cutting activity.

Profile of the Cuts. For the period 1974-77, 28 banking institutions cut their quarterly dividend. Out of the 28 banks, 2 cut in 1974, 10 in 1975, 12 in 1976, and 4 in 1977. These institutions range in size up to over $5 billion in assets, and they are located in many areas of the country, with concentrations in the Northeast and Southeast (Figure 1).

The cuts ranged in size from 3 cents to 50 cents a share and from 25 percent to 100 percent of the dividend level paid in the preceding quarter. Thus some of the cuts were sizable. But even where they weren’t, the mere fact that they occurred was remarkable (Figure 2).

Performance Before the Cuts. A look at the financial condition of those banks prior to the dividend cut shows that dividends were not cut from a position of strength but

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5 The banks that cut their dividend were identified from annual data for the period 1973-77 on the 350 largest banking institutions as contained in Keele Bankbook 1978 (New York: Keele, Bryeute & Woods, Inc.). The information from this source was then checked for stock splits, stock dividends, and declaration dates using Moody’s Dividend Record (New York: Moody’s Investors Service, Inc.). The statistics presented in the text mainly reflect performance of bank holding companies rather than of individual banks.
took place because of serious earnings and liquidity problems. For the most part, the analysis of the operating performance of the cutting banks was done by Judith Hanson, Banking Analyst, Federal Reserve Bank of Philadelphia.

The sample was restricted to the 16 banks for which information was readily available. How the cutting banks fare in this kind of comparison can depend upon which banks are chosen as matching banks. For a bank to be selected as a matching bank, it had to be of the same approximate size as the cutting bank, be headquartered in the same approximate geographic location, and have maintained or increased its quarterly dividend during the period under study. Banks was down less at 0.13 percentage points. Earnings per share of the cutting banks fell $2.96 while their dividends per share fell 13 cents. Over the same period, earnings were down 19 cents but dividends rose 14 cents at the matching banks. The payout ratio for the cutting banks increased by 76 percentage points while that for the control group rose 12 percentage points over this period.

Most of the dividend cuts have been attributed to a combination of financial setbacks either caused or exacerbated by the economic recession that began in late 1973. Many of the losses were related to a depressed real estate market and some were the result of unprofitable nonbank subsidiaries. As asset quality deteriorated, charge-offs increased and earnings were depressed by the need for additional provisions for loan losses.

All in all, at least one part of the traditional view seems to apply to these dividend cuts—the part which says that banks cut dividends only under severe earnings conditions. The other part of that wisdom says that a cut is
nearly disastrous. What is the evidence on
this from the group of banks under consider-
ation?

WERE THE CUTS DISASTROUS?
In a certain sense, whether the dividend
cuts were disastrous for the cutting banks is
impossible to determine. What might be
viewed as a disaster by one banker could be
seen as merely some tough going by another.
What can be done, however, is to consider
deposits, share prices, and operating per-
formance at the cutting banks.

Impact on Deposits. If it’s true that a
dividend cut is a “signal” of “trouble that will
not go away soon,” a cut could make depos-
itors begin to worry about the safety of their
deposits. Fortunately, most depositors have
little to be concerned about in this regard.
Bank accounts are insured for up to $40
thousand by the Federal Deposit Insurance
Corporation; so as long as the cutting bank
carries FDIC insurance, there is little need
for account holders with $40 thousand or less
in each account to worry. Accounts of more
than $40 thousand are not insured for the
excess, however, and so their owners might
be expected to be scared off by a dividend cut
if anyone would. But even here the cutting
banks don’t appear to have suffered steep
deposit losses.

While checking the movement in just this
latter category of deposits requires very de-
tailed records, we can make a rough pass at
determining the impact of the dividend cuts
by examining movements in total deposits
around the time of the cut. Average total
deposits for the cutting banks and for a group
of matching banks that didn’t cut dividends
are plotted in Figure 4. The matching banks
are comparable in size to the cutting banks
and are located in the same geographic areas.
Around the time of the dividend cuts, deposits
for the matching banks were rising while
those for the cutting banks were falling
slightly. This is generally what the traditional
view says will happen. Nevertheless, tests
on these movements in deposits do not show a
statistically significant decline on average in
the deposits of the cutting banks as compared

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**Figure 4**

**AVERAGE DEPOSITS DECLINE SLIGHTLY AROUND TIME OF DIVIDEND CUT**

- The quarter of the cut is designated zero. The numbers of quarters preceding the cut and following the cut are given by (-4) and (+) respectively. Average deposits are average total deposits as of either June 30 or December 31.

**SOURCE:** *Falk’s World Bank Directory.*
to the matching banks. If the cutting banks suffered losses in any deposit category, these losses apparently were not severe enough to affect their overall deposit positions relative to those of the matching banks.

Impact on Stock Prices. The share price of a bank can be taken as an indication of investors’ assessments of that bank. If the dividend cut indicates to investors that profit prospects are declining, their evaluation of the bank could become less favorable and the price of the bank’s stock could drop after the announcement of the dividend cut.

Average stock prices for the cutting group and the matching group are shown in Figure 5. The average share price for the cutting banks falls in the quarter of the cut and shows little recovery in the five quarters that follow.

*Statistical tests were conducted for total deposits, share prices, and three measures of operating performance. In every case, the value for each cutting bank was divided by the corresponding value of its matching bank, and the change in this ratio from one period to the next was computed. The one-tail t-test then was used to test the hypothesis that the average change in these ratios from one period to the next was equal to zero. The tests were conducted for three consecutive periods beginning with the one immediately preceding the dividend cut. Data for total deposits were taken from Polk’s World Bank Directory (Nashville, Tenn.: R. L. Polk & Co.), various issues, and are as of either June 30 or December 31. Share prices are the bid prices as published in the Commercial and Financial Chronicle and are as of the last week in either March, June, September, or December. The three measures of operating performance are earnings to assets, nonperforming asset to loans and other real estate owned, and earnings per share. Data for these are as of December 31 and can be found in Keefe Bankbook 1979. The tests were conducted using the 95-percent confidence level.

The impact of a dividend cut might be reflected also by measures that haven’t been examined in the course of this study. These include holdings of Federal funds (excess reserves that banks lend to one another for short periods) and rates paid for borrowed funds. In the case of share prices and deposits, it was assumed that no new information about the bank became available to investors or depositors between the dividend cut announcement and the next share price or deposit observation. It was assumed also that any loss of deposits was the result of actions initiated by depositors and not the result of a bank decision to reduce the level of its deposit liabilities.
follow. For the matching group, the average share price rises slightly at first and then more rapidly in subsequent quarters.

Statistical tests show that in the quarters surrounding the cut, the share prices of the cutting banks did not fall significantly compared to those of the matching banks. In the quarter of the cut, however, the share prices of the cutting banks dropped an average of 21 percent while prices for the matching banks rose by an average of three percent.9

**Operating Performance After the Cut.**

The impact of a dividend cut on a bank's ability to attract equity capital and deposit funds at a reasonable cost obviously has to make a difference to bank management. Perhaps the bottom line, however, is how it affects operating performance. While this is not easy to determine, a look at some measures of operating performance can provide an idea of how the cutting banks have fared since the time of the dividend cut.

On the whole, cutting banks have made significant strides toward improving their operations (Figure 6). Nonperforming assets dropped from 7.1 percent of total assets in 1975 to 5.3 percent in 1977, and earnings per share increased from an average loss of 49 cents to a gain of $1.11 in two years. As might be expected, the average dividend per share at the cutting banks was down to 48 cents from $1.18 over the same two years. In addition, the cut in dividends along with the improvement in earnings permitted a drop in the payout ratio from an unsustainable 128 percent to a much more manageable 40 percent. All in all, it appears that the cutting banks made significant inroads into the conditions that led them to cut their dividends. They not only survived the dividend cuts but also made progress in getting their financial houses back in order.

**Toward A Reassessment**

How does the traditional view stack up in

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9Depositors may view the dividend cut favorably since it provides them with additional protection against future losses. Investors may view it unfavorably, however, since it reduces current income and occurs at a time when the bank's earning opportunities don't promise a higher return later on.

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**FIGURE 6**

OPERATING PERFORMANCE IMPROVES AFTER CUTS

| 1975     | -0.02% | 7.12% | 1.19% | -3.45 | $1.18 | 125.1% |
| 1976     | 0.07   | 7.11  | 1.55  | -0.37 | 0.56  | 99.5   |
| 1977     | 0.22   | 5.28  | 0.91  | 1.13  | 0.48  | 100.0  |

**MATCHING BANKS**

| 1975     | 0.67   | 6.18  | 0.84  | 3.00  | 1.36  | 49.7   |
| 1976     | 0.61   | 4.68  | 0.78  | 2.90  | 1.59  | 52.2   |
| 1977     | 0.64   | 3.56  | 0.49  | 3.31  | 1.44  | 44.6   |

light of these recent dividend cuts by large bank holding companies? First of all, the part of the view that says dividends are cut only when a bank has no alternative does seem to hold in these cases. It appears that dividends were cut reluctantly and only after maintaining them became extremely difficult. The cuts did not take place because bankers spurned the conventional wisdom. Secondly, the part that says a dividend cut will have dire consequences doesn't fit as closely, at least not in its extreme versions. Investors appear to have lowered their assessments of the banks, since, on average, the share prices of the cutting banks fell significantly compared to those of the matching banks. In terms of total deposits, however, there is no evidence that the cutting banks suffered in relation to the matching banks around the time of the dividend cut.

With the traditional view in mind, it would be tempting to attribute the drop in stock prices to the fact that the dividend was cut. But to do this would be jumping the gun. Investors may have received other information that caused them to lower their assessments of the banks' prospects. They might be reacting to a drop in earnings, announcements by management, or public forecasts by bank stock analysts. Without detailed systematic information on these other possible sources of bad news, there's no way to tell how much of a negative impact, if any, is the result of the dividend cut.

But while the verdict isn't on the precise impact of dividend cutting, a look at the performance of cutting banks shows that whatever that impact was, it has not prevented these banks from making steady progress in getting their financial houses back in order. In short, while the recent experience with bank dividend cuts suggests that the traditional view still has some truth to it, the part of it that says a dividend cut will be the death knell of a bank should be reexamined. For banks that find themselves in the same boat as the cutting banks, a dividend cut may be a prudent step toward improving long-run health.

SUGGESTED READINGS


From the Philadelphia FED...

THE RULE OF 78's
or
What May Happen When You Pay Off a Loan Early

Copies of this pamphlet, which explains how to figure the interest when you pay off a loan early, are available without charge from the Department of Consumer Affairs, Federal Reserve Bank of Philadelphia, P. O. Box 66, Philadelphia, Pennsylvania 19105.