Does Deferral of Bank Dividends Matter?

There is a lot of concern amongst investors (such as retirees) who rely on bank dividends for income that APRA is putting pressure on our banks to suspend or reduce dividends to shore up their capital positions.

Should there be so much angst? Not really, but the situation does impose costs on such investors and require them to reorient their thinking to examine available alternatives to relying on dividend cash flows. Unfortunately, overcoming psychological impediments to change can be hard, even if the economics makes sense.

Generally, unexpected announcement of a dividend cut will cause a company's share price to fall. It signals that performance has been, or is expected to be, worse than was previously thought. But if the cut is a rational prudent response to already known economic woes there is less likelihood of a negative share price reaction.

In our current woes, the regulatory pressure provides cover for bank directors to take a prudent, but potentially unpopular, action of cutting dividends. It is prudent to keep earnings in the bank as a buffer against possible losses than to disperse those funds to shareholders via a dividend payment.

Is that harmful to shareholders overall? Not necessarily, although different types of shareholders will be affected and react differently.

Banks, like other firms, generate returns to shareholders either in the form of dividends or as capital gains from share price appreciation. Generally, given the bank's underlying performance (earnings), the more of one, the less of the other. Retaining earnings rather than paying dividends, and using those funds wisely, will cause the share price to increase and generate capital gains for shareholders.

Of course other factors (economic conditions, market mood, etc) can impact on bank share prices such that the link between dividends and share price change is somewhat obscured. But one time when it is very clear is when dividend payment time comes around every six months.

When a bank stock goes ex-dividend (so that subsequent purchasers of the stock are not entitled to the already announced, forthcoming, dividend), the price falls. If the bank decides not to pay the dividend, the share price will not fall, and shareholders benefit from a higher share price rather than if the dividend is paid. If they want cash, they could sell some of their shares at that higher price to replace the dividend cash flow lost.

So, why might some shareholders be unhappy? One reason is the "bird in the hand" fallacy – a preference for the certainty of the dividend cash in the pocket rather than an equivalent amount held in risky shares if the dividend is not paid.

The fallacy is that the bank share price will be more volatile if the dividend is paid out, relative to the case where it is not. The "safety" of the dividend is offset by the greater risk of the shares owned.

A second reason is that some shareholders have been relying on the dividend cash flow as an important source of income. While, if the dividend is not paid, they could instead sell some of their shares to generate cash, psychological attitudes mean that many are averse to what is actually a rational response.

Perhaps more importantly, though, and this is a third reason, they may be financially worse off due to losing tax benefits arising from the dividend.

In general payment of a fully franked dividend of $1 tends to lead to a share price fall of around $1. If that dividend wasn't paid, the shareholder would benefit by a $1 higher share price but lose the dividend. Unfortunately, for zero-tax-rate investors, that $1 franked dividend is actually worth around $1.43 because they receive a $0.43 cash rebate from the ATO for the unused franking credits.

Not all shareholders will feel worse off though. Investors on tax rates higher than the company tax rate (of 30 per cent) generally prefer concessionally taxed long term capital gains to franked dividends. So they, and foreign shareholders to whom the franking credits are of no value, will probably prefer the deferral of dividends.

Deferral of dividends by the banks in this time of crisis makes economic sense to shore up their capital position as a buffer to absorb possible future loan losses and enable continued lending to assist crisis management and recovery.

Retirees, heavily reliant on income from bank dividends, will be adversely affected but can sell some of their bank shares to partially offset the loss of dividend cash flow.

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