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Dividend payouts: Evidence from U.S. bank holding companies in the context of the financial crisis

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ABSTRACT

We study dividend payouts of 462 U.S. bank holding companies before and during the 2007–09 financial crisis. Fama and French (2001) characteristics (size, profitability and growth opportunities) explain dividend payouts before and during the financial crisis. The agency cost hypothesis explains dividend payouts before and during (more pronouncedly) the financial crisis. The signaling hypothesis explains dividend payouts during the financial crisis. Regulatory pressure was ineffective in limiting dividend payouts by undercapitalized banks before the financial crisis. Our findings have implications for corporate finance and governance theories, and also for the regulatory reforms that are being discussed among policymakers.

1. Introduction

Researchers apply corporate finance and governance theories to financial firms on the grounds of the inherent interplay of interests of a wider set of stakeholders (depositors and regulators, as well as shareholders and managers), which make their agency and governance problems more complex, and the relevance of financial firms for the good functioning and soundness of modern financial systems (see, among others, Anderson and Campbell, 2004; Brook et al., 2000). The financial crisis has further enhanced the interest in the application of corporate finance and governance theories due to the unique macroeconomic context and the regulatory shift which is believed to have hit financial firms the most (see, for example, Erkens et al., 2012). We contribute to this emerging strand in the literature by studying banks' dividend payout decisions before and during the financial crisis.

Of the several corporate finance and governance issues that are attracting the attention of scholars, dividend policy is receiving significant attention, particularly from regulators and investors. The recent proposals to increase oversight of the dividend payouts by the Federal Reserve Board (FRB, 2011) and the Basel Committee on Banking Supervision (BCBS, 2011) point towards the increasing regulatory relevance of banks' dividend payout policy. Forcing banks to plowback their earnings may however have the unintended consequence of reducing their ability to both signal their future growth prospects to suppliers of debt and equity, and reduce agency conflicts of their managers with dispersed shareholders. Our paper sheds critical light on the tension between

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the dividend payout decisions (before and) during the financial crisis by explicitly considering the major regulatory shifts that occurred during this period.

Although not new,[2] the regulatory focus on dividend payouts by banks contrasts with the minimal attention paid to the issue in the literature, especially because empirical tests on dividends commonly exclude financial firms due to the specificity of their leverage and reporting norms, thus hindering direct comparisons with non-financial firms (Foerster and Sapp, 2005). However, the fact that banks are regulated and supervised raises questions about the extent to which theories developed for non-financial firms are applicable to financial firms.

Dividend policy in the context of financial firms has been addressed to some extent previously. We summarize the main studies in Table 1. For example, Filbeck and Mullineaux (1993), Collins et al. (1994) and Boldin and Leggett (1995) test the signaling hypothesis and the evidence largely indicates that dividends are used as a signaling mechanism by banks. These studies do not account for the influence of regulatory pressure. An exception though is Theis and Dutta (2009) who in their study on the influence of the inside ownership on dividend payout control for the level of capitalization of banks. We extend these studies by considering the Fama and French (2001) characteristics of dividend payers, and the agency cost hypothesis alongside the previously tested signaling hypothesis. In addition, and so that the agency context in which financial firms operate is explicitly factored in, we deploy several measures of regulatory pressure based on the minimum capital requirements.

Regulators impose a minimum level of capital and recommend that banks operate with an adequate level of capital above that minimum (i.e., a capital buffer that protects debtors against losses and, hence, against the possibility of failure).[3] In the wake of the 2007–09 financial crisis, regulators were heavily criticized for the inadequate amount of minimum capital required by their frameworks (see, among others, Allen and Carletti, 2010; Goodhart and Persaud, 2008). To address this inadequacy, the Basel III proposal incorporates a more challenging definition of capital and strengthens the capital requirements. Furthermore, the proposal explicitly requires banks to conserve a certain amount of capital above the regulatory minimum to build buffers in "good times" that can be used to absorb losses during "bad times". The capital conservation buffer is specifically defined in the proposal and should be met with common equity. Additionally, national regulators have the discretion to demand larger buffers in periods of excessive credit growth (the countercyclical buffer). Although banks are allowed to draw on the buffer during periods of stress, plowback of earnings will be imposed if banks fall into the buffer range, and these constraints will increase as their actual capital ratios approach the minimum requirement (BCBS, 2011).

Broadening the scope of the restrictions placed on dividend payout, the Federal Reserve Board also requires large bank holding companies to submit their capital plans to the Federal Reserve on an annual basis. Furthermore, the Board has asked these banks to provide prior notice to the Federal Reserve under certain circumstances before making a capital distribution, which can be overruled by the Federal Reserve (FRB, 2011). These circumstances include the existence of unresolved supervisory issues, the inability to maintain capital above the minimum requirements, the inappropriateness of the capital plans and distributions, and the presumption of unsound or illegal practices.

We test four hypotheses in the present study: (i) the applicability of Fama and French's (2001) characteristics of dividend payers (size, profitability and growth opportunities); (ii) the signaling hypothesis, which states that dividends are used as an indicator of future prospects; (iii) the agency cost hypothesis, which states that dividends counterbalance the increased need for monitoring associated with independent banks; and (iv) the regulatory pressure hypothesis, which states that undercapitalized banks tend to retain earnings rather than pay dividends. The analysis covers two distinct macroeconomic environments: before and during the financial crisis. The sample includes 462 U.S. bank holding companies and contains 435 observations made before the financial crisis (i.e., from 2004 to 2006) and 441 observations made during the financial crisis (i.e., from 2007 to 2009), for a total of 876 observations. Focusing on the U.S. provides a large dataset, while restricting the sample to bank holding companies reduces the problems associated with unobserved heterogeneity.

A major finding of our study is that dividend policy depends on the macroeconomic conditions (i.e., before and during the financial crisis). The findings indicate that Fama and French's (2001) characteristics of dividend payers can be applied to banks in both periods. That is, the larger, more profitable and low growth banks pay more dividends in both periods. Evidence also supports the agency hypothesis in both periods, although it is stronger during the financial crisis. The signaling hypothesis on the other hand only applies to the period during the financial crisis. Regulatory pressure was ineffective at limiting undercapitalized banks' dividend payouts before the financial crisis, justifying the implementation of regulatory reforms.

We contribute to the evolving body of literature examining corporate financial decisions in the banking industry in several ways. First, the Fama and French (2001) characteristics of dividend payers are extended to the case of banks. Second, previous studies focus primarily on the Fama and French (2001) characteristics, the agency and signaling determinants of the dividend payers without controlling for regulatory pressure. Third, the present study assesses the dividend policy during the 2007–09 financial crisis, which as an exogenous shock to the economy, provides an interesting setting for the study of corporate finance and governance decisions. Finally, this paper contributes to the regulatory reforms that intend to constrain dividend payments under certain limiting conditions.

[2] For example, the 1933 Home Owners' Loan Act required the thrift subsidiaries of holding companies to give notice of dividend distributions 30 days in advance (Kroszner and Strahan, 1996). More recently, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 restricted capital distributions for banks classified as undercapitalized under the PCA thresholds.

[3] The Basel Accords promoted the international harmonization of minimum capital requirements, and both the Basel I and II frameworks provide national supervisors with discretion to define higher levels of minimum capital. The design of Basel II is clearer on this aspect: Pillar 1 defines the minimum capital requirements, while Pillar 2 explicitly addresses the need for supervisors to assess the adequacy of internal capital while considering all the material risks.