SETTING DIVIDENDS

by Steve Brown

While most do not agree with us, one sound basis for helping choose a university for your kids is to base the decision on parking. While it may seem shallow to overlook the student-to-teacher ratio, type of courses offered, graduation rate and a host of other important factors; we beg to differ. After all, despite all their tenured professors and noble laureates, we find it peculiar that these bastions of higher learning can't figure out that people want to drive to campus. At most colleges you either have to park 2 miles away and walk in, or pay $10 per day, park 2 miles away and still walk in. Either way it is a problem and we argue that questions regarding the parking-to-student ratio and cost of a parking ticket, should definitely come out in the all-important interview process.

Another issue that seems to be an afterthought relates to bank dividend policies. Like having enough parking spaces when you build educational buildings, banks must build a strong dividend culture as they grow. Banks that continue to pay and increase dividends, while raising fresh capital at the same time, are destroying value. Unfortunately, we are seeing this more and more. Some of this behavior stems from the confused notion that because dividends send a marketing message, they should be kept at some fixed level or increased by a certain percentage each year. Tell your equity holders that seek stable returns to buy your debt instead. Equity, by its very nature, should provide an element of capital flexibility for the bank. It should pay a higher return than debt, due to its greater uncertainty. Making equity certain, while attractive in the short run, can be destructive for banks in the long run.

When deciding when to pay a dividend, we might suggest 2 approaches. One is to use a modified version of the dividend discount model, where dividends are set based on expected growth and expected ROE of the bank. For example, if a bank is expected to grow at 4% and has an ROE of 8%, it can afford to pay out about 50% of its earnings. This methodology can be adjusted to pay out a similar portion of free cash flow, but the concept is the same. The underlying assumption here is that the Board is comfortable with its capital-to-risk ratio and that this ratio is not expected to change in the immediate future.

Another method of setting dividends that create value is one that is based on regulatory or economic capital requirements. This methodology is preferred where a bank's risk profile is changing. Here, asset growth is estimated by each risk category, required capital is assigned based on risk and the difference is paid out in annual dividends. It should be noted that the assigned capital should include a buffer in-line with the valuation volatility in each asset class. In other words, the more volatile the asset class (because of credit, higher rates, etc.) the greater the buffer required. It should be noted that banks that build in a bigger buffer will be safer and have a lower cost of equity, whereas banks that are more aggressive in both their asset holdings and regulatory capital policies will have higher costs of equity.

Not getting lock into a fixed dividend is important and so is looking ahead to be sure your bank has the right capital level for the projected risk that it hopes to take on. Finally, it is important to question whether your bank is producing an appropriate return given its risk. Banks that face few prospects to achieve a 10%+ ROE, are most likely best served by reducing growth and returning capital in the form of dividends. That way, returns (after adjusting for tax ramifications) are equalized in investor's minds. Doing so, will also help ensure dividend policies are as strong as branch parking availability (which has always been much better than those found at the colleges).

BANK NEWS

Delayed

The CFPB said it will delay requiring banks (under DFA) to collect and report on credit applications made by women and minority-owned businesses, until the CFPB issues the necessary regulations to implement. The requirement was originally set to become effective Jul 21; the date consumer financial protection powers are transferred to the CFPB.

Investor Changes

The SEC is considering increasing the 500 shareholder threshold for SEC registration to a higher number as it seeks to reduce regulatory burdens and improve small-business capital formation.

Taxes

The past 10Ys have delivered 4,428 changes to the tax code, or more than 1 per day. In addition, 60% of people pay preparers to do their returns and 29% use software. Finally, 45% of households owe no federal income tax for 2010.

Name Change

Bank of Montreal will change the name of its US banking arm by doing away with the Marshall & Ilsley name and consolidating the other two brands. Going forward it will go with "BMO Harris Bank."

Employee 401(k)

A study by Aon Hewitt finds the average employee contributes 7% of salary to a 401(k), below the 10% to 12% financial professionals suggest.