

## Does Deferral of Bank Dividends Matter - Appendix?

What does economic logic tell us happens to the bank's share price if it doesn't pay its usual dividend. Take a bank which has a share price of \$20 and normally pays a semi-annual franked dividend of \$1.

On the day the bank shares go ex-dividend, the share price will fall (to reflect the fact that purchasers of shares after that date won't be eligible for that dividend). How big is the fall? There are lots of academic studies trying to estimate the size of the fall. (The jargon uses the term dividend drop-off ratio for measuring the ratio of the price fall to the size of the dividend).

And, as you'd expect, where there's more than one academic researcher, there's lots of different answers to the question. (Actually, even with only one researcher, you could expect more than one answer!)

But, on what I think is a fair reading of the evidence from lots of studies, on average, the share price drop off from payment of a \$1 franked dividend will be around \$1. That's actually perplexing for many researchers since that seems to suggest that the franking credits attached to the dividend aren't worth anything!

While overseas shareholders won't value the franking credits, that's certainly not true for retirees and SMSF's and super funds on tax rates below 30 per cent investing in such shares. For those with a zero marginal tax rate such as retirees, the imputation credits augment the cash inflow from a \$1 franked dividend up to \$1.43 when the ATO pays the rebate of \$0.43 corresponding to the unused franking credits.

What is the net effect of the bank not paying the dividend. If it did pay the dividend, the shareholder on a zero tax rate would, after the ex-div date, have a share worth around \$19 and \$1.43 of cash coming from the \$1 franked dividend. If, instead the dividend wasn't paid, that investor would instead have a share worth around \$20, but no cash flow from the dividend.

If the cash flow previously provided by the dividend is critical for the investor a simple solution is to sell part of their shareholding at the price of \$20 to replace the lost cash flow. Yes, there are some costs. Because the dividend drop-off doesn't seem to incorporate the value of the franking credits, the number of shares needing to be sold is higher than it would otherwise be.

To illustrate, an investor with 10,000 shares would if the dividend had been paid have then had 10,000 shares worth \$19 each (\$190,000 in total), and cash from the dividend (including rebated franking credits) of \$14,300. This gives a total value of \$204,300. If the dividend is not paid, replacing the lost cash flow of \$14,300 would require selling 765 shares at \$20, leaving a holding of 9,235 shares worth \$184,700. Adding the cash flow from the sales of \$14,300 gives a total of \$199,000.

Yes, this investor would be worse off, but the non-payment of dividends is not "catastrophic".

**Kevin Davis**  
**Professor of Finance**  
**The University of Melbourne**  
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