
The Stock Market Reaction to Dividend Cuts and Omissions by Large Commercial Banks

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INTRODUCTION

This study intends to replicate a study done by Bessler and Nohel (1996) [BN] in which they look at the stock-market reaction to dividend cuts and omissions by commercial bank, for the period 1974-1991. The present study looks at the stock-market reaction for a different period of time: 1990-1999, especially for the largest U.S. banks. The sample ends up to be slightly the same, as most of banks dividend cuts happened in the two years 1990 and 1991 because of some managerial and regulatory reasons. Our results are also slightly different, but the difference is more obvious when we account for the announcement of earnings loss that happens generally at the same time as the dividend cut or omission announcement (dividend cuts and omissions will be referred to as dividend cuts.)

However, the results are substantially different when it comes to some individual banks. We find that one of the main reasons behind the positive abnormal returns following some banks dividend cuts is the banks dedication of the money for potential loan losses, which is a typical market reaction even for non-banks.

[BN] investigate 81 events of 56 banks, and their results indicate that, on average, banks experience significant negative abnormal return of -8.02% over the two-day window between days 0 and +1, and -11.46% over a two-week period from day -8 to +1. In this study, however, we find that on average banks experience significant negative abnormal return of -6.45% over the two-day window between days 0 and +1, with some abnormal return in the period $(-8,-1)$. These results come from tests using the prior 100 days, starting at day -11 , as the regression window. When changed to the 100 days following the event, starting at day +11 as the regression interval, our results show no abnormal return in the $(-8,-1)$ window, and the $(-1, 0)$ abnormal return decreases to -6.02% .

BANKS VS. NON-BANKS AND DIVIDEND CUTS

Banks vs. Non-Banks

For a number of years, it has been practically axiomatic among banking theorists and bank regulators that commercial banks were "special" or "unique" types of financial institutions. Banks have always played a singular role in the financial marketplace. Benston and Smith (1976) argue that the bank is fundamentally an evaluator of credit risk for the uninitiated depositor. It functions as a filter to evaluate signals in a financial environment with limited information (Santomero, 1984).

James (1987) finds that firms announcing new bank loans see their stock price increase significantly, but firms announcing private placement see their stock price decrease. Negative and significant abnormal returns follow the announcements of private placements and straight debt issues used to retire bank debt. Preece and Mullineaux (1994), however, show that equity markets react as favorably to announcements of loan agreements with non-bank financial firms and (though less conclusively) with non-bank holding companies subsidiaries as to similar announcements of financings with commercial banks.

If banks are perceived by investors as a special type of financial institutions, we can suppose that banks dividend cuts will produce a more pronounced negative abnormal return than would non-banks dividend cuts do.

Non-Banks Dividend Cuts

Dividend cuts are always bad news. Most of the empirical Finance literature (Healey and Palepu, 1988; DeAngelo and DeAngelo 1990; DeAngelo et al., 1992) describes a negative market reaction to dividend cuts by non-financial firms. Since dividend conveys information to the market, firms are reluctant to cut dividends especially when they are expected by investors to do so on a regular basis. DeAngelo and DeAngelo (1990) argue that it is in periods of financial distress that firms are usually obliged to cut their dividends.

Bajaj and Vijh (1990) report abnormal returns of -1.77% for a two-day event window, for non-banks firms during the period 1962 to 1987. For Nohel (1992) the average abnormal return for the two days event window is -3.03% during the period 1975 to 1990.

DATA AND RESULTS

The Data is based on the 100 largest banks in U.S. as of year-end 2000. Eighteen banks, over those 100, experienced dividend cuts over the period 1990-1999, four of them twice. 93 per cent of the dividend cuts happened between 1990 and 1991. [BN] also noted the high proportion of dividend cuts that happened during this two years period in their sample that covers the years 1974 through 1991. The complete sample is composed of twenty-two observations. Table 1 presents the summary statistics of the data available.

Table 1 Dividend Cuts by US Largest Banks between 1990 and 1999

Type of dividend cut	Percentage of cut	Number of banks
Suspension		4
Omission		4
Cut	Less than or equal to 50%	6
	More than 50%	8

Out of the twenty-two dividend cuts, eight were dividend suspensions or omissions. The average dividend cut for the other banks was 51 per cent. We start our abnormal returns tests using the prior 100 days, starting at day -11 , as the regression window. Table 2 presents the average and median abnormal returns on the announcement period, and the cumulative average abnormal returns for all banks announcing dividend cuts.

Table 2 Announcement Period Excess Return (-100 days regression window)

Day	Average Abnormal Return	Median Abnormal Return	Z
-8	-1.10%	-0.44%	-2.08**
-7	-0.66%	-0.50%	-1.32
-6	-0.49%	-0.53%	-0.51
-5	0.32%	-0.48%	-0.63
-4	-1.21%	-0.21%	-0.72
-3	0.16%	-0.20%	-0.32
-2	-0.81%	-0.73%	-1.07
-1	-0.21%	0.28%	-0.04
0	-3.19%	-0.05%	-6.20***
+1	-3.26%	-2.98%	-5.45***
+2	0.72%	1.88%	1.61
+3	-0.23%	-0.52%	-1.85
+4	-0.54%	-0.15%	-0.40
+5	-0.22%	0.18%	-0.76
+6	-0.77%	-0.57%	-0.42
+7	-0.87%	-0.52%	-1.35
+8	1.50%	-0.94%	0.91
	Cumulative Average		
Days	Abnormal Return		Z
(-8, -1)	-3.99%		-2.29**
(0, +1)	-6.45%		-8.27***
**	Significant at .05	***	Significant at .001

There is a statistically significant -6.45% abnormal return during the period (0, +1). We also find a negative abnormal return during the period (-8, -1), which may be due to information leaks about the dividend cuts at this period of time. To check the validity of our results, the regression window is changed to 100 days after the event day, starting at day +11. Table 3 presents the new results.

The cumulative abnormal return for the two-day interval (0, +1) is now -6.02%. This result is lower by two basis points than the results reported by Bessler and Nohel (1996). However, other studies report different numbers. Keen (1983) finds a cumulative abnormal return of -15% for the period of 1974-1977. Poloncheck et al. (1989) report -7.87%, for the same two-day window, based on 19 announcements of banks dividend cuts. Moreover, using the 100 days after the event day as the regression window does not show any statistically significant abnormal returns for the period (-8, -1).

Table 3 Announcement Period Excess Return (+100 days regression window)

Day	Average Abnormal Return	Median Abnormal Return	Z
-8	-1.48%	-1.52%	-1.60
-8	-1.28%	-0.79%	-1.44
-7	-0.63%	-0.43%	-0.88
-6	-0.40%	-0.54%	-0.30
-5	0.51%	0.07%	-0.49
-4	-1.14%	-0.38%	-0.69
-3	0.19%	-0.18%	-0.19
-2	-0.45%	0.14%	-0.71
-1	-0.21%	0.20%	-0.05
0	-2.74%	-0.71%	-3.52***
+1	-3.28%	-3.29%	-4.14***
+2	0.69%	1.20%	1.37
+3	-0.10%	-0.71%	-0.80
+4	-0.46%	-0.46%	-0.36
+5	-0.30%	0.17%	-0.74
+6	-0.90%	-0.75%	-0.74
+7	-0.97%	-0.65%	-0.80
+8	1.55%	-0.75%	1.06

Days	Cumulative Average Abnormal Return	Z
(-8,-1)	-3.39%	-1.63
(0,+1)	-6.02%	-5.44***

*** Significant at .001

REGRESSION ANALYSIS

We use Ordinary Least Squares to estimate the coefficients on percentages of dividend cuts in a regression where the dependent variable is the cumulative abnormal return over the two-day event interval. The results are presented in table 4.

Table 4 OLS Regression of Cumulative Abnormal Returns on Percentages Dividend Cuts

$Cumulative\ abnormal\ returns = \beta_1 + \beta_2 \text{ Percentage dividend cut} + \varepsilon_i$		
β_1	β_2	R^2
0.571 (0.090)	-0.0091 (-1.022)	0.06

The coefficient on the dividend cuts is not statistically significant. However, when we exclude from the sample the dividend cuts that were not due to losses, the coefficient becomes statistically significant at the 95 per cent confidence level (Table 5). The *R-square* indicates that the dividend cuts explain 33 per cent of the variation of the abnormal return.

Table 5 OLS Regression of Abnormal Returns on Percentages of the Dividend Cuts, when the Cuts are Due Solely to Losses

<i>Cumulative abnormal returns</i> = $\beta_1 + \beta_2$ Percentage dividend cut + ε_i		
β_1	β_2	R^2
2.938 (0.567)	-0.177** (-2.320)	0.33

** Significant at the 5% level.

SUMMARY AND CONCLUSIONS

Investors consider commercial banks as unique types of financial institutions. Hence, they rely more in their transactions, on the banks' dividend policy based information signaling than they do in the case of non-financial firms. The literature shows that non-banks dividend cuts produce abnormal returns between -1.5% and -3% during the two days event period. Our findings support the hypothesis that banks cutting dividends experience a larger negative abnormal return than do non-bank firms. We find that this cumulative average abnormal return varies around -6%.

The results of this study differ from those of Bessler and Nohel (1996), in that the cumulative abnormal return is not as large as the one they find. One reason for that may be the fact that in this study only large banks data are used. This could explain some of the differences in the results as the investors may react differently to dividend cuts by banks of various sizes.

We also find that some banks experience positive abnormal returns following the announcement of dividend cuts. Those are mainly banks that announce that they would put aside the money saved from the cut to use it as reserves for loan losses.

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