Federal Reserve Bank of San Francisco

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Business Review

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Higher Payout?

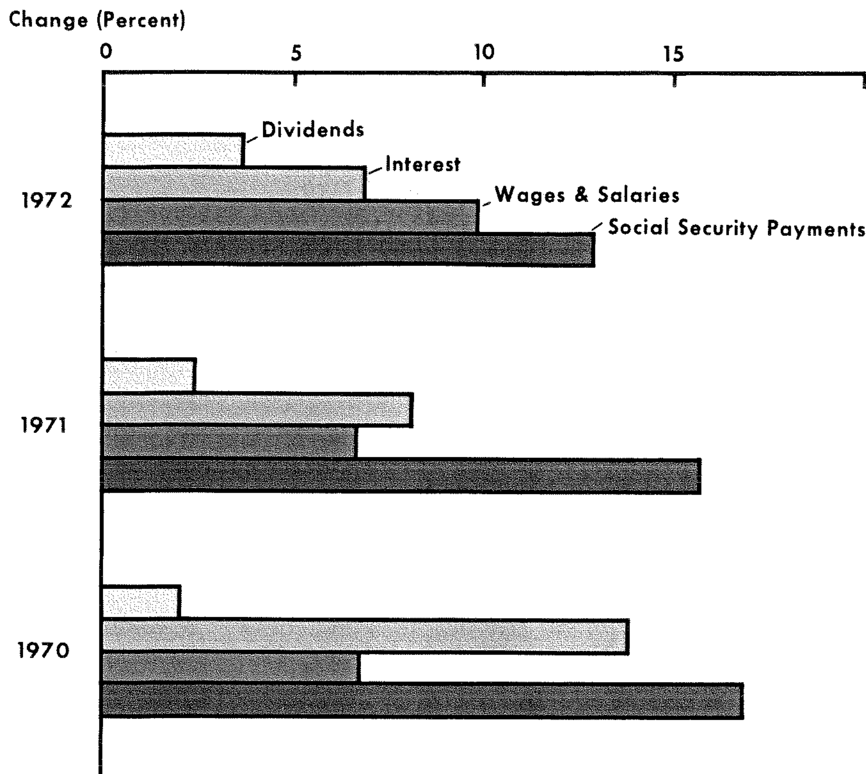
Widows and orphans (and other investors) got a lift recently when the Committee on Interest and Dividends (CID) eased its guidelines on corporate dividend payments. As a welcome side-effect, this ruling helped check temporarily the downward slide of the stock market, as stockholders came to realize that higher yields on their investments were at least possible, even if price appreciation should continue to be a mirage.

The new guidelines allow firms to continue operating under the old standard, which limits increases in payments to no more than 4 percent over the prior year, but they also provide a second option which bases current payments on historical payout ratios for the last five years. The new option provides that the aggregate cash payment per share in 1973, calculated as the percentage of per-share profits after taxes in the last completed fiscal year, cannot exceed the firm's average payout ratio for the 1968-72 period.

The Economic Stabilization Act of 1970 included no provisions regarding dividend or interest payments, but in the 1971 freeze, the Secretary of Commerce requested the 1300 largest corporations to forego dividend increases temporarily. As the freeze period ended, the CID set the 1972 guidelines, requesting firms to limit increases to 4 percent above the largest per-share dividend paid during calendar 1971 or the fiscal years 1969-71. The 4-percent guideline continued during Phase III, and that option is still available to corporate managers, along with the option to base their payments on historical payout ratios. The new option takes as the standard the same span of years as is used for monitoring profit-margin performance under the stabilization program.

Why dividends lag

Dividend payments in the aggregate have lagged considerably behind the growth of other types of income over the past several decades, especially in the most recent period. In recent years also, payouts have lagged far behind earlier dividend growth. These payouts were held down by the poor performance of profits during the sluggish 1969-71 period, and were also affected by the CID guidelines as the economy moved out of recession.



Dividend payments increase at slower pace than other forms of income, such as wages, interest and social security

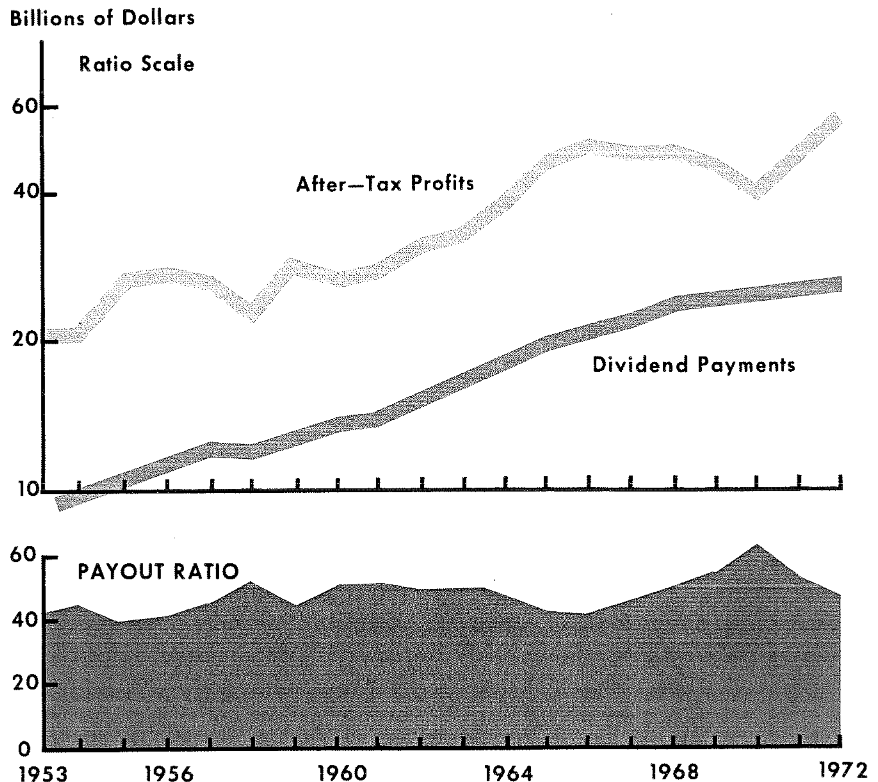
Between 1967 and 1972, dividends increased only 22 percent, to $26.0 billion last year, as against gains of 50 percent or more in employee compensation and personal interest payments. Meanwhile, social-security and other transfer payments actually doubled. Except in 1968, increases of dividends were relatively small throughout this period. After several years' sluggishness, dividends rose by 3½ percent in 1972, roughly in line with the guideline increase, but in contrast, interest payments last year increased about 7 percent, employee compensation 10 percent, and social-security payments 13 percent.

Dividend payments have closely paralleled corporate profits over time. (Both tripled in size over the past two decades). Consequently, with profits rising only 19 percent between 1967 and 1972, dividend payments not surprisingly were held to a 22-percent increase.

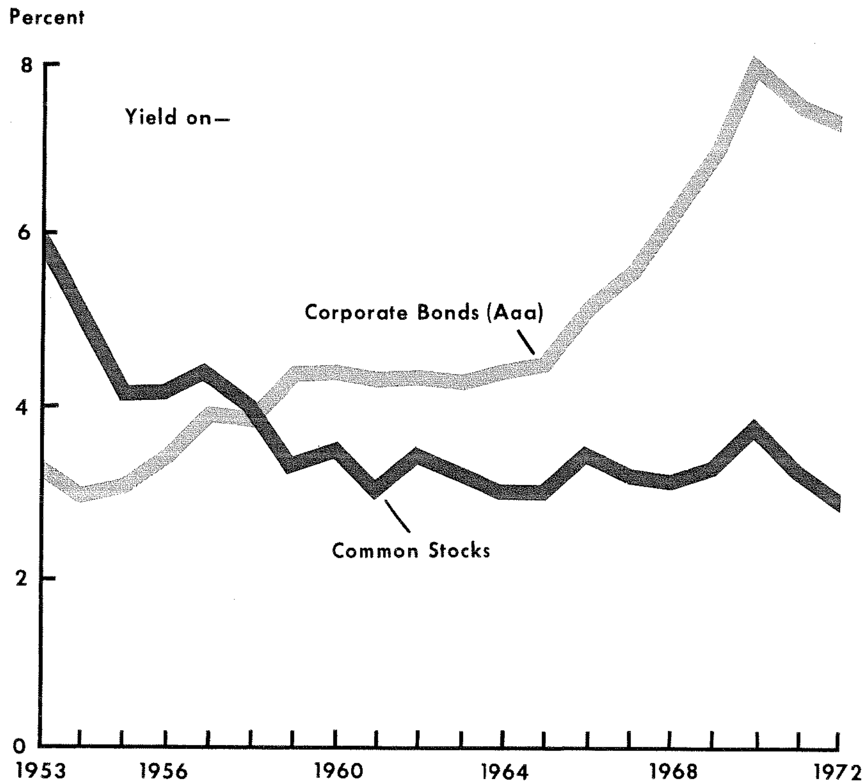
The payout ratio meanwhile has fluctuated considerably, reflecting the tendency for corporate directors to adjust dividend policy to profits performance with a certain lag. In 1967, corporations paid out 46 cents for every profit dollar, but the ratio later rose as a consequence of

modest increases in dividends and sharp declines in profits. In the 1970 recession year, the ratio jumped to 63 percent—the highest level of the past generation—but then fell off again in line with the recent recovery in profits. In the first quarter of 1973, the ratio fell to 40 percent, partly because of the lag in adjustment to that profits upsurge, but also because of the payout limitation enforced by the old CID guidelines.

Several different considerations affect the dividend decisions of corporate managers. According to a recent Conference Board study, most managers look first at corporate earnings records, present and prospective, when deciding on the size of payout. This involves an analysis of the firm's cash flow and anticipated need for funds. Also, corporations frequently are influenced in their decisions by past dividend practices, and this shows up in attempts to maintain the continuity or regularity of dividend payments, or to maintain a stable rate of dividends per share. Seven out of ten surveyed firms targeted their payout at somewhere between 40 and 60 percent of after-tax profits each year. With profits now rising and CID guidelines easing, all these policy considerations would suggest a substantial expansion of dividend payments as time goes on.



Dividend payments closely parallel growth of corporate profits, but payout ratio shows substantial fluctuations



Dividend yield on stocks falls considerably below bond yield over past several decades . . . gap widens in recent years

Bonds favored

Nonetheless, for several decades now, investors have been turning to bonds rather than to stocks as a source of current income. In 1953 dividend payments totaled $8.9 billion, as against $11.8 billion in interest payments. But in the second quarter of 1973, dividends were $27.3 billion (at an annual rate) compared with $85.7 billion in interest payments.

One reason for the relative disenchantment may be the weakness of stock prices, at least over the last half-decade. (After rising almost 50 percent between 1962 and 1967, the Standard and Poor stock index increased only 19 percent over the past half-decade). Related to this is the fact that bond yields far outstripped dividend yields during that period, making stocks even less desirable.

It was not always thus. In 1953 dividends provided a 5.80 percent yield for the S&P stock index, while the corporate-bond yield averaged no more than 3.20 percent. By 1967 these figures were almost exactly reversed, and since then the spread has widened even more in favor of bonds. By the first quarter of 1973, the dividend yield was only 2.78 percent, compared with a 7.22-percent bond yield.

Dividends slighted

During the market upsurge of the past several decades, dividend payouts seemed far less important to Wall Street money managers than potential increases in earnings per share. In those days, the securities that seemed most attractive often paid nominal dividends or none at all; according to one analysis covering the period 1960-70, the most profitable firms paid out on the average only 25 percent of their net income, while the least profitable paid out 60 percent in dividends. Because of this emphasis on profits growth, investors and corporate managers preferred to see earnings piled back into expansion or diversification that would produce further increases in earnings per share. But then, as the "gunslingers" era on Wall Street came to an end, investors began to adopt a more traditional approach and showed renewed interest in yields.

One stock-market study conducted at the University of Chicago indicates that dividends have always comprised a large part of the total return to investors. Over the 1926-65 period, the average annual return amounted to 9.3 percent, and over one-half of this return came from dividends rather than price appreciation.

Higher payout?

The recent CID action may stimulate corporate directors to boost dividend payments. In fact, the Committee noted that "it was guided primarily by considerations of equity" in easing payout restraints—in other words, that it was attempting to provide parallel treatment for different types of income. At the same time, the continuation of the basic guidelines indicates that an upper limit will be maintained on the size of payout. Under the old 4-percent guideline, total dividend payments this year could rise to about $27.0 billion, whereas under the new option, the upper limit may be around $29.2 billion.

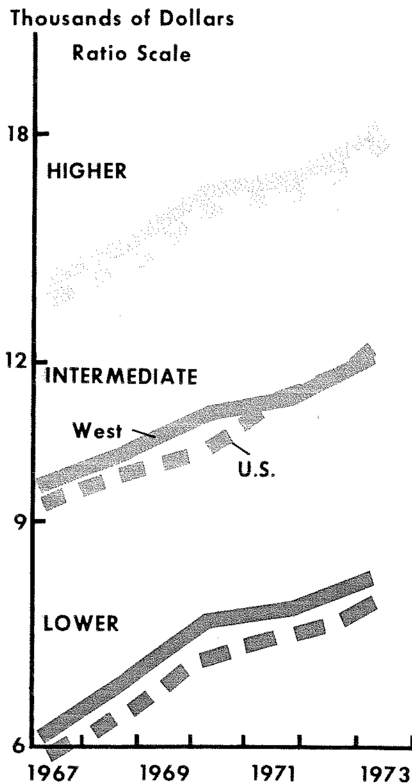
Executives might be tempted for reasons of their own to set a limit on dividend increases. They realize that external funds could dry up in the developing atmosphere of financial stringency—despite that fact that the corporate sector is usually the last to be hit by tight money—and they know also that many other uses besides dividends exist for corporate cash, such as heavy capital-spending programs.

With Phase 4 controls now set in place, industries generally may have trouble maintaining profit margins, because of the switch from a percentage mark-up to a dollar-for-dollar passthrough of cost increases. Moreover, some industries (such as transportation) that have considerable leeway under the new formula for boosting dividends are in no position to do so because of their lack of profitability. In any case, the percentage of after-tax profits paid out in 1973 is almost certain to fall somewhat below 1972's 47-percent ratio, simply because the new formula applies to 1972 earnings instead of the much higher projected 1973 profits.

However, considerably more leeway for higher dividends would exist next year, if the new formula were then applied to 1973 profits—and if the overall profits trend were to remain favorable in the face of Phase 4 controls and perhaps also a decelerating economy. After-tax profits jumped 26 percent, and cash flow 20 percent, between the first quarter of 1972 and the first quarter of 1973. In view of those increases, as well as the usual tendency for dividend payouts to follow profits trends, dividends quite possibly may begin to grow apace with other types of income.

William Burke

Western Consumer Budgets



Budget levels rise rapidly over past half-decade

The intermediate (moderate) budget for an urban Western family of four amounted to about $11,780 in the fall of 1972, and with adjustment for rising prices, the same budget probably would have cost about $12,180 in the spring of 1973. The figures represent population-weighted averages based upon Labor Department budget estimates for major metropolitan areas in the West.

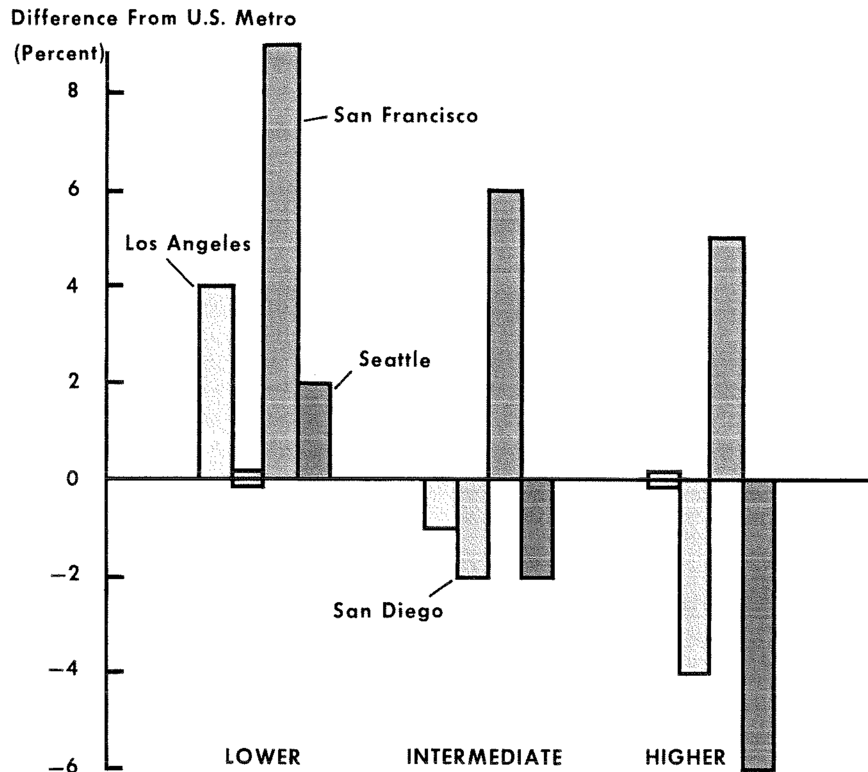
Based on the same survey data, average budget costs for lower-income Western families amounted to $7,925 last fall, while the average "higher" budget costed out at $17,260. (Again, with prices rising, the same budgets this spring would have cost about $8,170 and $17,850, respectively.) The Western lower-budget figure recently has averaged about 5 percent higher than the figure for all metropolitan areas nationwide, but the averages for intermediate and higher levels have been almost identical for the region and the nation.

Budget levels rose substantially in the half-decade between the spring-1967 and autumn-1972 survey periods, reflecting sharp price increases in various consumer categories as well as shifts in personal-income and social-security taxes. The average lower-income family budget in the West rose about 30 percent over this period, while the intermediate and higher budgets both increased almost 25 percent. (In all cases, however, the increases over this period were greater nationally than regionally.) The uptrend was not constant, but moderated somewhat during the 1970-72 period, as a reflection first of income-tax reductions and then of controls on consumer prices.

The Bureau of Labor Statistics computes budget estimates for an urban family of four: a 38-year-old employed husband with considerable work experience, his non-working wife, a boy of 13, and a girl of 8. The budgets are illustrative of three different levels of living and provide for different specified types and amounts of goods and services. The data show that food spending declines relative to income, accounting for roughly one-third of the consumption budget at the lower level and for roughly one-fourth at the higher level. In contrast, these proportions are practically reversed for housing and house-furnishings. Roughly one-seventh of the total is allocated to clothing and personal care at all three levels, and for transportation (one-tenth of the total) the proportionate differences between the levels are also small.

The manner of living represented by the lower budget differs from that in the intermediate and higher budgets primarily because the family lives in rental housing without air conditioning, performs more services for itself, and utilizes free recreation facilities in the community. The life style reflected by the higher budget, in comparison with the intermediate budget, represents a higher level of homeownership, more complete inventories of household appliances and equipment, and more extensive use of services for a fee. For most of the items that are common to all three budgets, both the quantity and quality levels increase with rises in income levels.

In late 1972, family budgets for the lower living standard were above the national average in most of the major Western metropolitan areas. The figure for San Francisco-Oakland was 9 percent higher than the $7,510 average for all metropolitan areas, while Los Angeles-Long Beach exceeded the average by 4 percent and Seattle-Everett by 2 percent. San Francisco-Oakland was third highest in the nation in this lower-budget category, but it was surpassed by two other Western communities, Honolulu and Anchorage, which were 21 and 48 percent above the national average, respectively.



Westerners generally pay more at lower budget levels, but pay less at higher levels—except in San Francisco

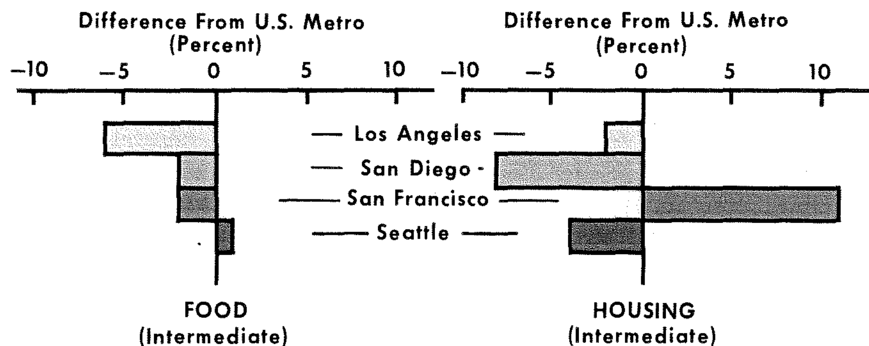
In the intermediate- and higher-budget categories, only San Francisco-Oakland, of the major metropolitan areas, exceeded the national average. (Again, however, Honolulu and Anchorage were by far the highest-cost areas in the nation.) The Bay Area's intermediate budget was 6 percent above the national figure of $11,730, and its higher budget was 5 percent above the $17,110 nation-wide; on the other hand, Bay Area living costs fell considerably below costs in such major Eastern centers as Boston and New York.

Food-spending patterns last year varied somewhat from the national pattern, in all three budget categories. Seattle paid higher-than-national food costs, and San Francisco was about average, while Los Angeles and San Diego

paid somewhat below-average costs in all categories. On the other hand, Honolulu was the highest-cost area in the nation, paying 15-20 percent more for food at all income levels; and Anchorage was also considerably above average.

Housing spending was much higher in the West in the lower budget, but generally in line with the national average at intermediate and higher levels of living. In the lower category, Los Angeles was 10 percent more costly and San Francisco 20 percent more expensive—and Anchorage was twice the national average. In other budget categories, San Francisco homeowners paid somewhat above average and Anchorage and Honolulu far exceeded the national average, but homeowners in Los Angeles, San Diego and Seattle remained closely in line with the national housing-cost figures.

Western families in San Francisco paid somewhat more than average for clothing and personal care, in all budget categories, but the Los Angeles and Seattle figures were roughly in line with the national averages. As for transportation costs, families in the largest Western centers paid somewhat more than average in the lower-budget category, but little if any above average in other categories, except again for San Francisco. Medical costs were another story; in all three budget categories, Los Angeles families paid about 20 percent more than the national average for medical care, and San Francisco and San Diego families paid about 10 percent more.



Westerners of moderate income generally pay less for food and housing than other metro residents—except in San Francisco

RCPC's - Transitional Step

A major transitional step towards the payments system of the future has been taken with the development of a nationwide network of facilities for the overnight processing and settlement of checks—the regional check processing centers (RCPC's). In the San Francisco Federal Reserve District, this step encompasses the opening of RCPC's this summer at the Seattle, Portland and Salt Lake City branches of the bank. (Los Angeles and San Francisco are scheduled to open centers later in the year.) Nationwide, the Federal Reserve System may soon have close to 50 such centers in operation, mostly at existing locations—12 head offices and 24 branches—but also at some newly developed sites.

The Federal Reserve Board of Governors issued guidelines in early 1972 authorizing Reserve Banks to operate regional check-processing centers in "communities whose trade, business and financial activities are substantially related". The objective was to ensure that most of the 62 million checks written every day be cleared and paid by the opening of business the day following the deposit of those checks.

An RCPC accepts from participating banks in its clearing region all checks written on other banks in the region. It also accepts from Federal Reserve member banks all checks drawn upon banks outside their region. In addition, it accepts from participating banks all U.S. Government checks, postal money orders and other items payable at Federal Reserve offices, regardless of origin.

Huge workload

The Federal Reserve's emphasis on the development of a speedier and more efficient check-handling and clearing system comes from the realization of the huge size of the present workload—some 25 billion checks transferring about $13 trillion annually—and from the expectation that this workload will double by the end of the decade. (The Federal Reserve processes about 30 percent of the nation's checks, and commercial-bank facilities handle the rest.) For the same reasons, the System believes that an improved check-payments system should be regarded as a transitional step

towards the use of electronic transfers rather than checks for transferring funds. System guidelines thus specify that each RCPC should be provided with an automated clearing and telecommunications ability, to provide a basis for a system of electronic transfers.

The present system of check processing typically involves two or three banks between the time a check is deposited and the time it is presented for payment. During this period, uncollected funds are not available to the checks' depositor—nor to his bank for loans or investments. The aim of regional centers is to reduce the number of times a check is handled. Each RCPC serves a specific geographic area, processing checks written and deposited within the area. The system builds upon the fact that about 70 percent of all checks remain within the metropolitan area in which they originate.

From credits to debits

With RCPC's, the Federal Reserve in a sense converts an inflow of credits into an outflow of debits. The checks that a regional center receives are credits to the bank which sends them into a center, so that when these items are resorted and rebatched they leave the RCPC transformed into charges on other banks. The process is ideally accomplished when the crediting and debiting effects are simultaneous, and when the shipping, sorting, accounting, and processing procedures can be performed between the close of business one day and the opening of business the next day.

The new system will bring about an earlier receipt of funds due to individuals and businesses, as well as an earlier payment of funds that they are transfering to others. To assist this development, the Federal Reserve revised its Regulation J in November 1972 to promote faster check collection. This amended regulation requires all banks to pay in immediately available funds on the day when checks are presented. Previously, banks located outside cities containing Federal Reserve offices (and other designated areas) had paid the Fed for checks presented in funds collectable one or more days after presentation.

Interface with the banks

Federal Reserve banks, when operating RCPC's, will expand the overnight check-settlement arrangements they have maintained for years with banks in major metropolitan centers. In addition, new RCPC's are envisioned as operating in areas not reached by existing Fed offices, wherever check volume and the absence of alternative facilities make additional Federal Reserve services essential. The system is designed to tie-in with commercial-bank processing centers, where checks from a number of correspondent banks are sorted and otherwise made ready for clearance.

The Federal Reserve's role is to serve as an interface among all banks in the nation. However, it is concerned only with "transit" items, not with the internal work of check sorting and accounting for individual banks. Commercial banks increasingly are using their own or contractual electronic-processing units for their internal check-processing operations.

The resultant economies in the Federal Reserve's check-handling program should show up eventually in reduced costs of personnel, transportation and equipment, considering as a whole all private and public check-processing costs. Savings could develop, for example, by reducing the number of times a check is reintroduced as a document in electronic processing operations. Similarly, savings could result by reducing duplicate transportation facilities between sites, and also by eliminating unnecessary and circuitous movements of checks.

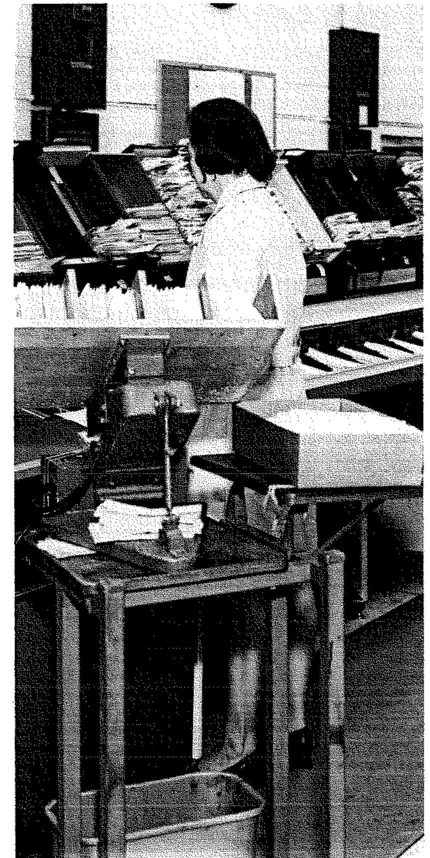
Regional variation

Operating arrangements at different clearing centers may vary somewhat, because of the substantial differences that exist in banking structure, population density, the volume of check traffic, and the geographic and topographic influences on transportation routes. In the latter regard, the size of an RCPC service area is determined chiefly by the time required to pick up during an afternoon the day's volume of checks deposited in participating banks, to bring these to a clearing center for processing and settlement during the night, and to deliver them early the next morning to banks against which checks were drawn the day before.

As for banking structure, the workload of the San Francisco Federal Reserve Bank is eased because the states in this district generally contain a relatively small number of statewide branch systems, rather than a large number of unit banks. The big branch systems, in effect, have set up their own regional clearing centers, so that the Federal Reserve's task in many cases consists simply of integrating its new RCPC's with ongoing commercial-bank systems.

Under the San Francisco District's plan, an RCPC will be set up at each existing Fed office. Because of the vast geographic size of the areas served by each of these offices, existing transportation arrangements may preclude the timely presentment of checks to payor banks in certain remote locations, meaning that there will be a small number of two-day cash-letter delivery points. The operational plan calls for each RCPC to reduce the number of these two-day points by improving transportation arrangements. All costs of each RCPC, except for transportation costs of incoming cash items, will be borne by the Federal Reserve Bank of San Francisco.

The schedule generally calls for incoming work to arrive at the RCPC late each evening, although some offices (especially Los Angeles) should encounter a substantial inflow of items at other times throughout the day. These items would be processed and ready for dispatch early in the next working day. Outgoing items would be delivered before noon of that day, except for a few remote areas with next-day delivery. Prior to the start-up of operations, however, several important preliminary steps are necessary—for example, conducting orientation meetings for participating banks, organizing



Gearing Up

Gearing up for around-the-clock operations at new regional check-processing centers requires extensive behind-the-scenes planning at this Bank's Seattle, Portland, and Salt Lake City offices. The Seattle office will be the busiest, with the average daily RCPC volume expected to be 450,000 items. This volume will be followed by Portland with 250,000 items and Salt Lake City with 186,000.

There will be 57 employees at the three offices keeping the operation going on the night shift. About a dozen new employees are being added to the RCPC staff, and supplemental mailroom employees are being hired to handle the additional night volume. More new workers will later be added to staff the Los Angeles and San Francisco RCPC's.

Cafeteria personnel are being mobilized to provide hot meals for those working the night shift, and other arrangements (regarding parking, protection, extra lighting, and so on) are also being made to accommodate the necessary changes in work schedules.

In addition, teams of management personnel have traveled throughout the region to hold at least 17 group bank seminars, in order to acquaint commercial bankers with procedures for the new operation.

air and surface transportation routes, and realigning workshifts to permit three-shift operations (see note).

Demise of the check

The development of regional check-processing centers and the future development of an electronic payments system are tied in with the overwhelming success of the written check, which has been so successful an instrument that it now threatens to engulf the payments system. The check's usefulness to the banking industry has increased because it is highly compatible with advanced technology, typified by magnetic-ink encoding and machine-handling techniques. Similarly, its usefulness to individual users has increased because it is an inexpensive, highly efficient and convenient means for conducting the bulk of financial transactions.

Last year, individuals and institutions wrote more than 25 billion checks, against 94 million accounts with balances aggregating $192 billion. The check volume by the end of this year could amount to over 27 billion pieces, and with volume increasing by 7 percent annually, the total could double within a decade. (Those are volume figures; in dollar terms, the total could rise one and one-half times in just half that time.)

While the volume should increase because of the growth of the national economy and the growth in the number of check users, the complexity should also increase because of the labor-intensive nature of the check-payments system, involving an inordinate amount of expensive processing and physical transfers of paper. The paper glut may take its toll in the shape of suddenly rising user and purveyor costs, sharp reductions in productivity for making financial transactions, and all the other problems that could result from an overloaded system of payments.

Towards electronic payments

In the long-run, the check cannot survive in an increasingly complex economy which is growing rapidly in both real and money terms. The requirements of an ever-larger and more complex payments mechanism dictate a move away from dependence on paper payments and towards complete reliance on electronic transfer of funds and electronic accounting for those transfers. Thus, the development of RCPC's provides only a short-run structural solution to the payments problem; in the long-run, an operational solution is required through the expanded use of the Federal Reserve's electronic communications network.

Some widely reported experiments in electronic funds transfers are already underway. In California, the banks and clearing-house associations in San Francisco and Los Angeles, with Federal Reserve support, have developed a system of electronic transfers—the California Automated Clearing House Association (CACHA). This system permits an individual bank's customers to authorize employers to deposit their paychecks automatically into checking accounts every payday. In addition, individuals are encouraged to authorize payments by banks of their recurring predictable bills—mortgage and other loan payments, utility bills and insurance premiums. Commercial banks in Georgia meanwhile have developed a system with even greater potential for reducing check usage.

Already individuals account for at least half of all checks written, and this proportion could increase as more households make more purchases out of higher incomes. The obvious solution is to provide for accounting and payments for purchases through the use of electronic point-of-sale terminals. The credit card, or a similar means of activating electronic transfers, should play a major role in this development. Finally, the new RCPC's and the expanded check-clearing arrangements already developed in a number of metropolitan centers should become the nuclei of an interconnected regional-communications network for handling wire transfers of funds.

In any event, the payments mechanism increasingly should evolve in the direction of a system where the credit to a payee's account is made at the same time that a payor's account is charged. The expansion of the RCPC network, with its emphasis on the speeding up of check payments, is a necessary step in this evolution, as the Federal Reserve moves its weekly workload of 150 million checks to an overnight-settlement basis as rapidly as is economically feasible.

William Burke