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Banks dividend policy: Evidence from Pakistan

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ABSTRACT

The present study empirically investigates the factors that determine the dividend payout decisions among banks. For empirical analysis the data of sixteen banks listed in the Karachi Stock Exchange (KSE) are used. The results indicate that earning per share, last year's dividend payouts, capital ratio and size of the bank are crucial factors in the determination of dividend payouts, whereas cash flow is negatively associated with dividend payouts. The results support the Lintner model (1956) and also follow the transaction cost hypothesis.

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1. Introduction

Dividend payout policy is one of the most debated topics and a core theory of corporate finance which still keeps its importance. Many researchers presented various theories and empirical evidences, however the issue is still unresolved and open for further discussion. It is among the top ten unresolved problems in economic literature and one that does not have an adequate explanation for the observed dividend behavior of the firms (Allen and Michaely, 2003; Black, 1976; Brealey and Myers, 2005). In developed economies the investors and management of the firms decide very suspiciously whether to pay dividends or keep it as retained earnings (Glen et al., 1995).

The role of dividend is still like a puzzle. There are several reasons whether businesses should pay dividends or not. A number of hypotheses have risen to get rid of some light on this puzzle but the problem is still there. Normally a firm faces the problem in allocation of earnings, whether to distribute among shareholders or retaining for reinvestment. The retained earnings is a main internal source of financing, however higher retained earnings mean fewer dividends and vice versa (Black, 1976). The more profitable firms are, the more internal finance they have, hence, larger dividends. Practically every business adopts a dividend policy, which retains a portion of net earnings in such a manner that it will not comprise a threat to dividend payments. In literature there is no single explanation for dividend and researchers also do not agree on a single idea. The management can thwart from agency problems to pay a sufficient amount of cash dividend.

The dividend policy issue has significance due to several reasons. Firstly, the firm can use it as a tool for financial signaling to the outsider vis-a-vis the stability and growth prospects of the firm. Secondly, dividend plays a key role in a firm's capital structure. According to the "residual dividend" theory, a firm pays dividend only if she does not have any opportunity of profitable investment. Various researchers established a relationship between dividend and investment decision. Management normally does not like to reduce the dividend payments.

During the last fifty years, a lot of empirical and theoretical work has been done, summarizing all these studies; three dominating views can be concluded i) dividend payments can positively change the market value of the firm (Gordon, 1963; Lintner, 1956). ii) A positive change in the dividend decreases the firm's value (Litzenberger and Ramaswamy, 1979). iii) Dividend policy does not affect the market value of the firm (Miller and Modigliani, 1961). So it can be concluded that the factors determining the dividend policy are mixed and depend upon the firms as well as countries' policies and market structure.

The banks play a major role to facilitate the businesses as a financial intermediary in Pakistan, hence leading to growing investment and economic prosperity. However, there is no empirical study available in the case of Pakistan which analyzes or identifies the dividend policy behavior or factors of this important sector. Most of the studies on dividend behavior are based on non-financial firms in Pakistan (Eriotis, 2005; Fama and French, 2002; Glen et al., 1995; Imran, 2011; Javid and Ahmed, 2009; Nishat and Bilgrami, 1994; Smith and Watts, 1992). The objective of the present study is to empirically identify the various factors determining the banking sector' dividend paying behavior by using the sample of sixteen banks listed in the Karachi Stock Exchange (KSE), for the period 2000 to 2010.

The remaining paper is organized as follows. Section 2 provides literature review. Section 3 develops the empirical model and econometric methodology. Section 4 consists of empirical results, and the last section concludes the study.

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2. Literature review

Over the past 50 years great attention was given to determine the factors influencing dividend payment decision and a vast literature is available in this regard. However, the puzzle is still unresolved and open for further discussion. As Black (1976) raises the question, "Why do firms pay dividends?" and "Why do investors pay attention to dividends?" So depending on the market conditions and banks' own capital structure various factors can be considered as the determinants of dividend payout policy in the banking sector.

Miller and Modigliani (1961) were considered as the pioneer in this field. Their irrelevance theorem claimed that the firm's dividend policy is unrelated to its current market value. A number of researchers however do not agree with them due to their assumption of perfect capital market.

The firms can prevent from the agency problem by paying a sufficient amount of dividend. The dividend payouts are helpful for firms to keep them in the market. The managers make financial policy trade-offs to control agency cost in an effective way (Al-Malkawi, 2007; Crutchley and Hansen, 1989; Easterbrook, 1984; Naceur et al., 2005). A free cash flow is helpful for a business to share it with stockholders as dividends and pay the debt in order to reduce the possibility of these funds being wasted on unprofitable projects (Amidu and Abor, 2006; Jensen, 1986).

Banks' investment policies have a significant impact on its dividend payout policy; the banks with less investment plans have greater amounts to distribute as dividends. Due to the higher investment opportunities and internal needs various banks deprive from paying higher dividends to lower. So the investment opportunities have a negative association to the dividend payouts (Fama and French, 2002; Glen et al., 1995; Naceur et al., 2005; Naeem and Nasr, 2007; Smith and Watts, 1992).

The dividend policy is different in emerging markets as compared to developed economies, and seems to be affected by a number of factors (Al-Kuwari, 2009; Glen et al., 1995). Due to several reasons like tax pay procedure, stock market volatility and certain asymmetry information the dividend payout pattern is different in emerging markets as compared to developed nations. The firms with higher earnings, greater size and foreign ownership prefer to distribute a higher and constant amount in dividend payouts according to their earnings and size (Al-Malkawi, 2007; Dickens et al., 2002; Eriotis, 2005; Imran, 2011; Javid and Ahmed, 2009; Nishat and Bilgrami, 1994).

The higher and consistent dividend payments lead to a greater demand of its shares, and as a result the share price also moves upward (Glen et al., 1995; Nishat and Saghir, 1991; Pettit, 1972; Watts, 1973). So, to keep this success firms normally are unwilling to skip or diminish the dividend payouts (Saxena, 1999; Woolridge and Ghosh, 1985). The investment opportunities, ownership, signaling and risk have a negative relationship between dividend payouts, whereas firm size and the last year dividend have positive association with dividend payouts (Dickens et al., 2002; Imran, 2011).

Al-Ajmi (2010) and Imran (2011) support the Lintner model as well as the transaction cost hypothesis in the case of GCC Countries and Pakistan respectively. Adaoglu (2000) found a significant difference between dividend policy behavior of firms in emerging markets and in developed markets. Moreover their study also found that firms follow stable cash dividend policies in a regulatory environment that forced mandatory dividend policies. Taxes are also an important factor in the dividend payout decision; lower the tax rate on income (dividend) relative to the capital gains and make higher the payout ratio (the positive tax argument) Casey and Dickens (2000).

3. Data and model

Annual data of sixteen banks listed on KSE spanning time period from 2000 to 2010 are used for econometrical analysis. The data employed are derived from financial statement analysis of financial sector and various annual reports of the banks.

On the basis of selected variables the current study used the following econometric model

$$\mathrm{Div}_{it} = \beta_0 + \beta_1 \mathrm{EPS}_{it} + \beta_2 \mathrm{Div}_{t-1} + \beta_3 \mathrm{CR}_{it} + \beta_4 \mathrm{Size}_{it} + \beta_5 \mathrm{CF}_{it} + \mu_{it} \quad (1)$$

Div. is current year dividend, EPS is earning per share, Div_{t-1} is last year dividend, CR is capital ratio, Size measured as total assets of a bank and the CF is cash flow per share, whereas i and t represent individual and time period respectively.

4. Methodology

In econometric perspective the current study used the ordinary least squares method which is commonly used for panel data.

5. Ordinary least squares (OLS)

The most fundamental estimator in panel data sets is ordinary least squares (OLS). A simple OLS estimator ignores the structure of the data and deals it as being serially uncorrelated for a given individual, with homoscedastic errors across the individuals and time periods (Johnston and DiNardo, 1997).

The OLS regression assumes constant intercept and slopes despite of firm types. For simplicity consider the following bi-variate regression equation,

$$y_{it} = \beta_0 + \beta_1 x_{it} + \mu_{it}$$

where $\boldsymbol{\beta_0}$ is intercept, $\boldsymbol{\beta_1}$ is slope and $\boldsymbol{\mu_{it}}$ is the error term.

The **T** observations for individual **i** can be summarized as

$$y_i = \begin{bmatrix} y_{i1} \\ \vdots \\ y_{iT} \end{bmatrix}_{T\times 1} \qquad X_i = \begin{bmatrix} x_{it} \\ \vdots \\ x_{iT} \end{bmatrix}_{T\times K} \qquad u_i = \begin{bmatrix} u_{i1} \\ \vdots \\ u_{iT} \end{bmatrix}_{T\times 1}$$

β of the equation can be defined as

$$\beta_{OLS} = \left(X'X\right)^{-1} X'Y.$$

To expand it we get

$$\hat{\beta}_{OLS} = \frac{\sum_{i=1}^{N}\sum_{t=1}^{T}(x_{it}-\bar{x}_i)(y_{it}-\bar{y}_i)}{\sum_{i=1}^{N}\sum_{t=1}^{T}(x_{it}-\bar{x}_i)^2}$$

Table 1
Correlation matrices.

	Div	EPS	CR	Size	CF
Div	1				
EPS	0.289	1			
CR	0.049	−0.036	1		
Size	0.496	0.509	−0.156	1	
CF	0.233	0.244	−0.020	0.510	1

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