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.

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2. Literature review

Over the past 50 years great attention was given to determine the factors influencing dividend payment decisions 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).

Investment opportunities and internal needs various banks deprive from the higher amounts to distribute as dividends. Due to the higher investment opportunities and ownership, signaling and risk 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 nations. The higher and consistent dividend payments lead to a greater demand of its shares, and as a result the share price also moves upward (Al-Kuwari, 2009; Glen et al., 1995). Due to several reasons like tax policy, stock market volatility and certain asymmetry inform about the dividend payout decision; lower the tax rate on income (dividend) related 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

\[
\text{Div}_{it} = \beta_0 + \beta_1 \text{EPS}_{it} + \beta_2 \text{Div}_{i,t-1} + \beta_3 \text{CR}_{it} + \beta_4 \text{Size}_{it} + \beta_5 \text{CF}_{it} + \mu_{it}
\]

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,

\[
y_{it} = \beta_0 + \beta_1 x_{it} + u_{it}
\]

where \(\beta_0\) is intercept, \(\beta_1\) is slope and \(u_{it}\) is the error term.

The observations for individual \(i\) can be summarized as

\[
y_i = \begin{bmatrix} y_{i1} \\ \vdots \\ y_{iT} \end{bmatrix}, \quad X_i = \begin{bmatrix} x_{i1} \\ \vdots \\ x_{iT} \end{bmatrix}, \quad u_i = \begin{bmatrix} u_{i1} \\ \vdots \\ u_{iT} \end{bmatrix}
\]

\(\beta\) of the equation can be defined as

\[
\beta_{\text{OLS}} = \left(XX^T\right)^{-1}XY.
\]

To expand it we get

\[
\beta_{\text{OLS}} = \frac{\sum_{t=1}^{T} \sum_{i=1}^{N} (x_{it} - \bar{x}_i)(y_{it} - \bar{y}_i)}{\sum_{t=1}^{T} \sum_{i=1}^{N} (x_{it} - \bar{x}_i)^2}
\]

Table 1

<table>
<thead>
<tr>
<th>Correlation matrices</th>
<th>Div</th>
<th>EPS</th>
<th>CR</th>
<th>Size</th>
<th>CF</th>
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<td>0.049</td>
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<td>0.509</td>
<td>0.244</td>
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<tr>
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<tr>
<td>Size</td>
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<td>0.509</td>
<td>-0.156</td>
<td>1</td>
<td>0.510</td>
</tr>
<tr>
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<td>0.233</td>
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</tbody>
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