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Determinants of Dividend Policy Decision: An Analysis of Banks in India

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Abstract

This study explores the factors influencing dividend payout of Banks in India by using pooled regression, fixed effects model and random effects model approach in panel regression. The study considers 42 banks in India selected from banking sector of PROWESS database of CMIE for the period of 2006-2015. Profitability, liquidity and risk are the factors considered in influencing dividend payout decision. Profitability has a positive effect on dividend payout and it concludes that higher the profit of the bank, more they prefer to pay out the dividend. The liquidity of the banks found to have a positive effect on dividend payout and it confirms that higher the liquidity of the bank, more they prefer to pay out the dividend. But risk and leverage does not significantly impact the dividend payout decision of the selected banks in India.

Keywords: Banks, Dividend Policy, Liquidity, Profitability, Risk

1. Introduction

"Dividend" is the dissemination of profits to the shareholders of the company. The company's dividend policy relies on its future plan and the shareholders' trade-off analysis between the immediate interests and the future development of the company. The most crucial decision for any firm's financial policy is the dividend declaration as it is concerned with distributing the earnings of the firms amongst its shareholders. The dividend policy adopted by any organization has an inference in the real life for all, be it is a manager or it is an organization's stakeholders. Dividend decision is one among the difficult choice that the management must make in allocating their profit to reinvest within the company or distribute to shareholders. Investors give attention to dividends as they get a yield on their investment or opportunity to sell their stocks at a higher price in the future. Lenders look dividend sensibly as they sense that there will be fewer amounts available for redemption their claims if there is a tendency to pay more dividends.

Banking system is a very important component of Indian financial system as it is concerned with mobilizing savings from several sectors, which is the substance for progress and expansion of an economy. In recent years, the banking industry is gaining huge importance as the main objective of this industry to generate money in the economy. The main business of this industry has the characteristics of high risk, high liability and the creation of credit.

In developed countries, extensive studies have been done in factors influencing the dividend decision of the firms. India is one of the emerging economy and companies are frequently involved in dividend payments. A handful of studies is done on determinants of dividend policy

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of commercial bank have been conducted in India. Against the backdrop, it is worthwhile to study the factors determining dividend policy.

2. Review of Literature

A literature review summarizes previous research and gives the idea relating to direction of present research. For dividend distribution there are many studies having national and international evidences and the same has been discussed in this section.

International Evidences

Lintner (1956) proposed that dividend depends to the limited extent on the organization's present earnings and to some degree on the previous year's dividend. He additionally bargains that organizations likes to make periodic partial adjustments toward a target payout ratio instead of bigger changes in dividend payout. According to Lintner, managers may increase dividends once they are sure that they can sustain them at the new level consistently.

Brittain (1966) took as his beginning stage the model proposed by Lintner and obtained significant results, but at the same time, found that better results that could be obtained by certain adjustments and modifications. Brittain argued that cash flow is more significant factor, as it reflects more faithfully the true earnings. Further, also he considered present year's depreciation and present year's free cash flow as explanatory variable in his study for dividend payment.

Jahera and Page (1985) and Collins et al. (1996) and Rozeff (1982) all showed inverse relation between dividend payout policy and historical sales growth. Pruitt and Gitman (1991) reported that past year and current profits are significant elements that influences the dividend payments and found that risk (year to year variability of earnings) also govern the firms' dividend policy of 1000 largest U.S firms.

Kumudha and George (2006) in their research work on the dividend policy concluded that current earnings play an essential role in deciding the dividend policy. The outcomes of the study indicated that present year's dividend per share has positive relation with last year dividend per share and current years earning per share. Duha Al-Kuwari (2009) did a study the determinants of dividend payout of the companies listed on the GCC (Gulf Cooperation Council) country stock exchange for the sample of seventy-five companies for the period of 1999-2003. The result showed that profitability and size of the firm are the positively related to the firm's dividend and leverage is insignificantly related.

Jianguo Chen and NontDhiensiri (2009) did a study on the determinants of dividend payout ratio for sample of seventy-five firms listed on NZSE (New Zealand Stock Exchange) for the period 1991-99. Their findings showed that firms that experience rapid growth in the recent past tend to pay lower dividend. Seok Weon Lee (2009) did a research study on the factors determining dividend behavior of the banks in Korea for duration of 1994-2005. The main purpose of this research was to examine how the dividend policy of the firm relates with the bank's profitability and risk. The result reported that less risky and more profitable banks pay more dividends. Considering that banks are subject to monitoring, banks' dividend policy would be therefore more closely associated with their riskiness.

Maldajian and El Khoury (2014) did on Lebanese banks, which are listed on Beirut Stock Exchange during the period from 2005-11 and as a result a negative relationship was found out between dividend payout policy and company profitability.

Indian Evidences

Purnanandamand Rao (1966) did research work on fifty companies of cotton textile industry for the duration of 1946-63. Lintner's model proved to be proved to be good enough in explaining the dividend behavior. Krishnamoorthy and Sastry (1971) did analyze the dividend determining factors of the chemical industry for 1962- 67. It is a study of forty public ltd. companies.

Sudhahar and Saroja (2010) did an analysis work on the determinants of dividend policy in the Indian banks. The data was for 10 years. They analyzed them based on 20 BSE banks, where present year profit after tax and present year depreciation are considered as the significant variables. Devanadhen and Karthik (2015) analyzed factors that influence the dividend payout of Indian commercial banks by using a fixed effects approach in panel regression. The analysis considered 10 private sector banks and 19 public sector banks during the period from 2007 to 2014. Profitability, leverage, growth opportunities, risk, liquidity, and size were the factors considered in influencing dividend payout.

3. Research Methodology

The objectives of the present study are as follows:

1. To identify the relationship between dividend decision of Indian Banking Industry and their determinants.
2. To find out the impact of the risk, profitability and liquidity on the dividend payout decision of the banking industry.

Data Source and Period of Study

The data has been sourced from Prowess database of Center for Monitoring Indian Economy (CMIE).

Selection of Sample Banks

Initially data of 235 banks listed in BSE was available. Out of 235 banks, 133 banks were dropped due to incomplete information on all the variables chosen together in this study. Then out of 158 left banks, 116 banks were removed due to non-availability of information on Price - Earnings ratio. So, finally 42 banks were selected for the study. The purposive sampling method has been adopted for the sample selection.

Variables Description

Potential variables for determining dividend payout of the firm are selected from the previous literature. Profitability, liquidity and risk of the firm are selected as potential determinants of dividend payout of Indian commercial banks. The list of variables is summarized in Table 2.

Table 2: Variables Description under the Study

Variables	Symbol	Proxy	Description	Sources
		Dependent		
Dividend Policy	DPR	Dividend Payout Ratio	Dividend paid is divided by net profit after tax and then multiplied by 100	Fama (1974), Swamy and Rao's (1975), Smirlock and Marshall (1983),Badar Khalid (2001),George and Kumudha (2006), Duha Al-Kuwari (2009), SeokWeon Lee (2009)
		Independent		
Profitability	PRO	**Return on Total Assets**	Net profit before interest and tax is divided by total asset and then multiplied by 100	Higgins (1972), Pruitt and Gitman (1991), Fama (1974), Swamy and Rao's (1975), Smirlock and Marshall (1983), Badar Khalid (2001),
Liquidity	LIQ	**Current Ratio**	Current asset is divided by current liabilities and then multiplied by 100.	Hafeez Ahmed and AttiyaJavid (2009), NasirudeenAbubaker (2010), Ababa Ethiopia (2013), Zhong (2016),)
Risk	RIS	**Price Earnings Ratio**	Market price per share (MPS) is divided by Earning per share (EPS).	Pruitt and Gitman (1991), Rozeff (1982), Badar Khalid (2001), SeokWeon Lee (2009), Nasirudeen Abubaker (2010),
Leverage	LEV	**Debt Equity Ratio**	Debt used by the banks in order to finance their assets	Nasirudeen Abubaker (2010), Duha Al-Kuwari (2009)

4. Results and Discussions

There are two important methods that can be applied for a panel regression - - Fixed Effect Model and Random Effect Model. After applying the statistical software Eviews, the following results were obtained for each model:

Fixed - Effects Model (Fem)

The results for Fixed Effects Models are shown below:

Variable	Coefficient	Std. Error	T-statistic	Prob.
C	15.70785	1.460434	10.75560	0.0000
Current ratio (times)	0.151131	0.271964	0.555703	**0.5787**
Debt to equity ratio (times)	0.197342	0.589387	0.334827	**0.7379**
P/E	0.015716	0.020857	0.753505	**0.4516**
Return on total assets	1.083426	0.740121	1.463849	**0.1441**
R-squared	0.615022			
Adjusted R-squared	0.568701			

Source: E-views regression output, Significant at 5% level of significance

Random- Effect Model (Rem)

The results for Random Effects Models are shown below:

Variable	Coefficient	Std. Error	T-statistic	Prob.
C	13.93062	1.576374	8.837125	0.0000*
Current ratio (times)	0.504085	0.253468	1.988750	0.0474*
Debt to equity ratio (times)	0.375217	0.518050	0.724286	**0.4693**
P/E	0.006773	0.020175	0.335694	**0.7373**
Return on total assets	1.717836	0.696338	2.466957	0.0140*
R-squared	0.310567			
Adjusted R-squared	0.310136			

Source: E-views regression output, Significant at 5% level of significance

Analysis was made with the tool of regression analysis popularly known as Random Effect and Fixed Effect model and this give us the concrete results regarding the dividend decisions in the Indian banking industry.

Hausman Test

When Hausman Test was conducted to know which method is better for the respective data employed in the study amongst FEM or REM. Since p value was more (0.1486> 0.05) than .05, Thus null hypothesis was accepted and thus it was clear that Random Effect model is more suited to this study as compared to fixed effect model.

Thus it was found that out of the two regression methods, Random Effects Model (REM) worked out be better here. As per this random- effects model results,

- Debt to equity ratio and P/E are more than 0.05, therefore they do not significantly impact the dividend payout ratio at 5% level of significance.
- Current ratio and Return on Total Assets are less than 0.05, therefore they significantly impact the dividend payout ratio at 5% level of significance.
- Adjusted R-squared = 0.310136, thus explaining 31% variance by the independent variable to the dependent variable

Therefore we can say that Current ratio and Return on Total Assets statistically significantly impact the dividend payout ratio. This could be due to facts that the liquidity and profitability are very important for the functioning for any banks. Whereas Debt to equity ratio and P/E do not statistically significantly impact the dividend payout ratio at 5% level of significance for the Banks in India. Thus, having more leverage in the banking industry may not impact the dividend payment pattern of it.

5. Implication of the Study

There are number of decisions that have to be taken for the efficient performance and attainment of objectives in the banking sector. This study is giving the clarity with respect to various factors that affects the dividend decision of banking firms which in turn concerns with the profitability of banks and creation of the funds to serve the economy. The dividend policy decisions are of great relevance from the policy standpoint, because as dividend literature suggest, if these decisions are taken efficiently, this is expected to be reflected in value of the firms.

6. Conclusion

Profitability and liquidity are thus concluded to make a noteworthy favorable impact on the dividend payout decision of banks in India. Return on Total Assets which indicates profitability in our study, is positively and significantly impacting the dividend payout decision, which implies that higher the profitability of the bank, more they prefer to pay the dividend. Profitability represents the capacity of a firm to pay dividends and serves as good signal for the investor. So highly profitable banks distribute more in form of dividends.

Current Ratio which indicates liquidity in our study is positively and significantly impacting the dividend payout decision, which implies that higher liquidity of the bank, more they prefer to pay the dividend. Thus showing that banks having improved financial position initiate dividend increments. Price-Earnings Ratio (P/E) and Debt-equity Ratio which indicates the risk and leverage respectively in our study, do not significantly impacting the dividend payout decision. Thus they are found to be non-significant in impacting the dividend payout of Banks in India.

7. Suggestions

1. This study identified profitability and liquidity as the significant factors, having an influence on the bank's dividend decision. It may be referred for future researches in the same area under discussion. This result is very important for the policy makers of banks in India and thus may prove to be useful for re-sketching their dividend policy, keeping in view the results and discussions made.
2. Potential investors who want to invest in the banking sector and looking for cash dividend gain, they should give a great attention for the identified variables - profitability and liquidity since these variables have a positive significant impact on the banks dividend decision.

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