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OBJECTIVES
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AN EVALUATION OF DETERMINANTS OF DIVIDEND POLICY A STUDY OF THE BANKING SECTOR IN KENYA

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ABSTRACT

Recent financial crisis shows that excessive dividends lead to financial distress. Thus, there is a strong need for qualitative and quantitative restrictions on the dividends considering the potential conflict with debt-holders. The approach to dividend policy presented focuses on specific attributes of the firm as sources of value expression through dividend payment. Because of increasing complexities, competition, global and corporate structure, it is difficult to single out one single factor affecting dividend and dividend policy explaining why some companies pay dividends while others do not. The general objective of this study was to evaluate the determinants of dividend policy in the Kenyan banking sector. The specific objectives were to establish the effect of leverage on dividend policy among banks in Kenya, determine the effect of size of the firm on dividend policy among banks in Kenya, and investigate the effect of business risk on dividend policy among banks in Kenya. This paper focused on the agency theory, pecking order theory, the signaling theory, and the high dividends increase share value theory. Descriptive research design was adopted. The researcher sampled Kenyan financial banks listed in Nairobi Stock Exchange for a period of ten years from 2007-2016. Data were collected from the audited financial statements using Questionnaires and secondary information from capital Markets Authority. Data were analysed quantitatively using unbalanced panel estimation techniques.

KEYWORDS

dividend policy, leverage on dividend policy, financial distress, business risk, asset structure.

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INTRODUCTION

Dividend policy refers to a plan of action adopted by the firm whenever dividend decision is to be made. It is the third major financial decision the financial manager must decide whether the firm should distribute all the profits, retain them, or distribute a portion and retain the balance. This dividend payment should be determined in terms of its impact on the shareholders' value and provide information regarding the performance of the firm to the stockholders (Pandey, 2008).

The study of dividend policy is increasingly becoming interesting for several reasons. First, it affects the capital structure of the firm and also changes the firm's stock value (Nikolaos, 2005). Second, announcement of dividend signals information to investors about the firm's efficiency in terms of profitability, liquidity and investment opportunity (Alli, 1993). Third, through cash dividend policy, managers reduce principal-agent relationship costs (Brigham and Gapenski, 2002). The need to receive dividends forms part of the primary motive why shareholders buy shares. In subscribing for a firm's shares, investors always take into consideration a host of factors such as the size of the firm, business risk as well as leverage. As a result, management strives to command a fair price for her stocks while ensuring prompt payment of dividends.

Dividend payout is important to companies for some reasons. First, dividends provide certainty about the company's financial position. Second, dividends provide current income for investor's especially requiring security of income. Third, dividends may assist in maintaining a company's share price in the stock market.

Since the pioneering work of Miller and Modigliani (1958) in their seminal article, a series of empirical and theoretical research in dividend policy have emerged, some relaxing the assumptions of the Modigliani & Miller and offering theories and building models to guide managers formulate their dividend policy decisions. However, empirical evidences from these studies vary considerably (Gordon, 1963; Litner, 1962; kawal & Sujata (2008). Some suggest that increase in dividend payout increases the firm's market value; others posit that increase in dividend payout decreases the firm's value, while some argue that dividend policy does not affect the market value of the firm.

Dividend policy also involves judgmental decisions and that there has been emerging concern that there is no single explanation of dividend policy because of increasing complexities, competition, global and corporate structure therefore difficult to single out one single factor affecting dividend policy (Amidu, 2006)

In spite of the continuous and increasing theoretical and empirical debate on dividend policy, there is still no generally accepted standard on how firms actually pay out dividend to shareholders at a given time period. Thus, the dividend decision is a controversial issue, which still leaves some questions unanswered: What is the impact of dividend policy on value? What are the factors influencing dividend policy? Is dividend policy determined dependently or independently? What proportion of a firm's after tax income should be distributed to shareholders? Should the distribution be cash dividends or should the cash be passed on to shareholders by buying back some shares? The other important concern is how stable should the distribution be?

Despite empirical evidence suggesting similarities in macro-level characteristics within emerging markets, the evidence of firm-level investigations, such as dividend payout determinants, has displayed great empirical disparities. For example, while some studies have observed the impact of leverage on dividend policy to be significant and inversely related, others have noted leverage to have no implication for dividend policy. Similar divergences in evidence have also been observed regarding the effect of size of the firm on dividend payout.

With regard to the above contradictory evidence, this study contributes to the literature in two ways. First, it attempts to shed light on the issue of dividend policy in the context of an emerging market. Second, it examines dividend policy across financial sector, as it can be expected that different business types may plausibly differ in dividend payment policies.

IMPORTANCE

The findings of this study will give a better insight about determinants of dividend policy in the banking sector in Kenya. The findings would further aid in shaping future policy by the government on dividend policy and possible replication in the Kenyan finance industry. The findings are also expected to provide reference for educators and readers in general and rekindle further research in the area.

STATEMENT OF THE PROBLEM

Dividend policy is an integral part of financial management decision of a business firm. Issues related to dividend policy have been analysed for many years but no universally accepted dividend policy has been established. The evidence of firm-level investigations, such as dividend payout determinants has displayed great empirical disparities (Michel & Shaked, 1986; Travlos, 2001). Kang and Lee (2003) state that firms in different countries may follow different dividend policies because of differences in macro-economic environments, economic developments, regulations, tax systems, market transaction costs, and other institutional factors. Dividend policy has been associated with a host of factors which contradict amongst themselves in different researches among them leverage, size of the firm, and business risk. It is with this in mind that the researcher is inspired to conduct the study so as to identify the factors determining dividend policy in the Kenyan banking sector.

OBJECTIVES

1. To evaluate the effect of leverage on dividend policy among banks in Kenya.
2. To evaluate the effect of size of the firm on dividend policy among banks in Kenya.
3. To evaluate the effect of business risk on dividend policy among banks in Kenya.

HYPOTHESES

1. There is no known the effect of leverage on dividend policy among banks in Kenya.
2. There is no significant effect of size of the firm on dividend policy among banks in Kenya.
3. There is no effect of business risk on dividend policy among banks in Kenya.

METHODOLOGY

Descriptive research design was adopted. Data were collected from the audited financial statements using Questionnaires and secondary information from capital Markets Authority.

LITERATURE REVIEW

THEORETICAL BACKGROUND OVERVIEW

Three main contradictory theories on dividends can be identified. Some argue that increasing dividend payments increases a firm's value. Another view claims that high dividend payouts have the opposite effect on a firm's value; that is, it reduces firm value. The third theoretical approach asserts that dividends should be irrelevant and all effort spent on the dividend decision is wasted. These views are embodied in three theories of dividend policy: high dividends increase share value theory, low dividends increase share value theory, and the dividend irrelevance hypothesis. Dividend debate is not limited to these three approaches. Several other theories of dividend policy have been presented increasing the complexity of the dividend puzzle further. The theories behind this research are based on the models and theories given by researchers elaborating on important variables and factors, which affect dividend payout and capital structure of the company. These include the agency cost hypotheses, the pecking order theory, signaling theory, bankruptcy theory, bird in hand theory, and clientele effect theory. All these theories play an important role in explaining the reasoning behind the factors affecting capital structure and dividend payout policy of the firms. A brief explanation of the theories and variables will help us further comprehend the basis of the economic model.

AGENCY THEORY

Agency theory tells us about agency problem that exists due to the separation of ownership and management in organizations. The Agency theory was propounded by Jensen and Meckling (1976) who describe the relation between the owners and the managers as the relation between the principals and the agents. The managers are the agents or owners of the firm and can pursue such decisions that increase their own welfare rather than increasing the value of the firm. This situation leads to the conflict of interest between the owners and the managers of the firm. The agency models of leverage and dividend policy foretell that use of debt financing and dividend payments can work as tools to tackle with agency problem. According to Rozeff (1982), Easterbrook (1984) and Bhaduri (2002), both dividend payments and ability to issue debt can decrease the cash flows that are under the control of management. Jensen (1986) explains that dividend payments can reduce the agency problem through reducing excess cash flows in the organization. Reduction in excess cash flow makes cash less available to the managers to use for unproductive purposes. From the agency theory perspective, it is generally accepted by authors that leverage and dividend policy decisions are mainly influenced by institutional ownership, asset tangibility, and liquidity.

PECKING ORDER THEORY

The pecking order theory was first suggested by Donaldson (1984) and then developed by Myers and Majluf (1984) who explain that because of existence of asymmetric information, the companies follow an order while taking decisions about financing. The companies will prefer to finance their projects by retained earnings (the least costly source of finance); if the investment opportunities are not fully financed by the retained earnings then debt (the less costly source of finance) will be preferred to equity issues (the most costly source of finance). This order is favorable for companies as it reduces the chances of passing up profitable opportunities. Further, the pecking order theory says that the companies pay dividends after meeting the investment requirements. Profitability and liquidity of the firm will be used as a significant factor in leverage and dividend policy models.

SIGNALING THEORY

The signaling theory is based on the concept that there is an information asymmetry between managers and the investors of the firm. The work of Miller and Modigliani (1961) draws attention that dividend payments are signals to the market. If a firm is paying more dividends then it is taken as positive signal by the investors and it would appreciate the market value of the stock. If a firm is giving fewer dividends then it is taken as negative signal by the investors and it would reduce the market value of the firm. The work of Bhattachariya (1980) also explains that the firms use dividend payment as a signal to investors about its financial health. Ross (1977) contributed to the concept that the issue of debt is also used by the investors as a source of information regarding the performance of the firm. The investors take the issue of debt by the managers as a positive signal that the firm's profits are high and the managers do not want to share these high profits with outside investors. The firms having good financial performance can issue more debt because of the capabilities to repay loans while the firms with poor financial performance issue low level of debt because of low capabilities to repay loans. From the signaling theory perspective, institutional ownership and profitability of the firm can be used to examine the effect on leverage and dividend policy decisions.

HIGH DIVIDENDS INCREASE SHARE VALUE THEORY

In a world of uncertainty and imperfect information, dividends are valued differently to retained earnings (capital gains). Myron (1963) argued that investors prefer certain dividends to retained earnings since the stock price declines as dividends increase. This leads to firms setting a large dividend payout ratio to maximize fair share price. Investors prefer the bird in hand hypothesis of cash dividends rather than the two in the bush of future capital gains. Increasing dividend payments, ceteris paribus, may then be associated with increase in a firm's value. Empirical support for the bird in hand theory as an explanation for paying dividends is generally very limited, and the argument has been challenged especially by (Miller M.H., 1961)who argued that the required rate of return is independent of dividend policy, suggesting that investors are indifferent between dividends and capital gains.

EMPIRICAL LITERATURE

Although there are plenty of potential determinants for the dividend decisions, explanatory variables that are included in this study are only internal variables, which consist of profitability, firm size, debt level /leverage, liquidity, asset structure, industry type, growth opportunities and business risk are included.

LEVERAGE

High debt means that firms have high interest expense, which will lead to a low net income and thus less earnings will be available for shareholders. Dividend payments to shareholders may lead to suffering of financing and investment plans especially in case of high leveraged firms. Earnings of highly leveraged firms are more risky and volatile and accordingly pay low dividends. Highly leveraged firms tend to pay low dividends payouts in order to reduce transaction cost of external capital (Al-Twairjy, 2007) found negative relationship between leverage and dividend payout ratios of firms listed in Kuala Lumpur stock exchange and concluded that highly leveraged firms retain more instead of distributing profits to shareholders.

Kowalski (2007) argued that more indebted firms prefer to pay lower dividends. Also, Al-(Kuwari, 2009) confirms that dividend policy is negatively related to leverage ratio. However, (Mollah, 2001) examined an emerging market and found a direct relationship between financial leverage and debt-burden level that increases transaction costs. Thus, firms with high leverage ratios have high transaction costs, and are in a weak position to pay higher dividends to avoid the cost of external financing.

Appannan (2011) in their study of Malaysia listed companies for food industries under the consumer products sector showed that variables having a strong relationship with dividend payout are not necessarily the determinants of the dividend payment decision such as profit-after-tax that has the strongest relationship with dividend per share. The study further confirmed the fact that debt-to-equity ratio and past dividend per share were the important determinants of dividend payment.

FIRM SIZE

The size of a firm has been considered to be a factor in determining dividend policy of a firm. (Kinfe, 2011) undertook an empirical study on the determinants of dividend payout of six private banks in Ethiopia during 2006-2010 using lintners model, the study concluded that there was a positive relationship between the firm size and dividend payout ratio, a negative relationship between liquidity and dividend payout. However, there was no relationship between payout ratio and profitability, growth and leverage. He concluded that banks in Ethiopia considered agency conflicts, previous year's dividends and liquidity when making decisions so as to pay dividends.

Firm size is one of the major determinants of cash dividend payout. Larger sized firms have easier access to capital market. This reduces their rate of dependency on internally generated revenue and hence, fosters prompt payment of higher rate of dividend (Vogt, 1994). Studies by Gaver and Gaver (1993) also supported a positive relationship between firm size and dividend payout.

On the other hand, (Lloyd, 1998) concluded that size plays a prominent role in explaining firms' dividend policy. As firm grow, they mature, have easy access to financial market and become less dependent on internally generated funds which allow them to pay higher dividends. Large firms pay lower transaction cost as compared to smaller ones for raising new financing and pay more dividends. (Hafeez, 2008) in his study found positive relationship between the firm size and dividend payments whereby Investors perceive that larger firms are less risky hence are in a better position in the market and can raise more funds as compared to smaller firms and pay more dividends (Al-Malkawi, 2007) has concluded that size positively correlate with dividend payout ratio. They play an important role in reducing agency cost. Size plays significant negative impact on dividends reasoning that large firms reinvest their profits into assets instead of paying dividends to shareholders.

(Myers, 1984) Found that the asymmetric information situation between managers and external investors leads to underinvestment problems. Based on that, (Deshmukh, 2003)clarified this with respect with to the change in the dividend. When other things are constant, the higher the level of asymmetric information that can be shown due to the smaller firm size, the higher probability of underinvestment, and so the lower the dividend paid to stockholders. (Naceur, 2006) Results, based on 48 listed companies listed on the Tunisian Stock Exchange between 1996 and 2002, showed that smaller corporations want to disburse more dividends as they can catch attention of potential investors to lessen their inherent risks. Thus, there seems to be a relationship between firm size and dividend yield but there are still arguments about the direction of this association.

(Mehta, 2012) empirically investigated the determinants of dividend payout for all firms in the areas of real estate, energy sector, construction sector, telecommunications sector, health care and industrial sectors (except bank and investment concerns). The study analysed a range of determinants of dividend policy: Profitability, Risk, Liquidity, Size and Leverage of the firm. Correlation and the multiple regression techniques were applied to find out the most significant variables used by the UAE firms in making the dividend decisions. The study provides evidence that profitability and size are the most important considerations of dividend payout decisions by UAE firms.

BUSINESS RISK

(Nguyen.T., 2012) Results show that while profitability affects dividends payment positively, there is negative relationship between business risk and dividend disbursement to companies in the sample Vietnam. The results are consistent with previous empirical studies in the US (Li, 2008), the UK (Al-Najjar, 2009) defined business risk as the probability of decrease in returns on investment owing to exceptional circumstances. Under transaction cost theory, (Rozeff, 1982) suggested that the transactions costs of external financing will be higher when the firm has higher operating and financial leverage or more risks that can be measured through the greater beta coefficient. An association between dividend payments and industry type or audit quality is also found in this study that is similar to researches of (Baker H. a., 2000),specifically, regulated enterprises pay more dividends than unregulated ones and dividends among listed firms being audited by one of the ten biggest audit companies. The most important point is that among tested factors to the sample, profitability is the main determinant of dividend policy in Vietnam.

Lee (2009) investigated the determinants of dividend policy in Korean banking industry using a panel data of Korean banks between 1994-2005. The study found a positive relationship between the bank's profitability, bank size, and the dividend payout. They concluded that because banks were subject monitoring and surveillance from their regulator on their operations, the dividend policy would be more closely associated with their riskiness.

A brief scrutiny of the review of literature in this section reveals that a number of studies investigating the dividend behaviour of the companies abroad have been conducted. To the researchers, no study on determinants of the dividend policy of corporate sector in Kenya has been made to date. From the review of literature, it has been observed that there exists a general agreement on the set of factors influencing dividend policy. Different authors have used different combinations of variables to explain the dividend behaviour. Besides there are different approaches to the decision involving the distribution verses the retention of the net profit after tax. Again, the factors influencing corporate dividend policy may vary substantially from country to country because of inconsistencies or, the variation in legal, the tax and accounting policy among the countries. In view of these facts, the present day study aims at identifying the factors significantly that influence the corporate dividend policy in Kenya.

METHODOLOGY

Lee (2009) investigated the determinants of dividend policy on Korean banking industry using a panel data of Korean banks during 1994-2005. The study found a positive relationship between the bank's profitability, banks size, and dividend payout. They concluded that because banks were subject to monitoring and surveillance from the regulator on the operations, the dividend policy would be more closely associated with their riskiness.

In comparative study of Australia and Japanese firms, Ho, (2003) opined that out of all regressed variables of profitability, size, liquidity, risk, asset mix and growth, the dividend policies are affected positively by size in Australia and liquidity in Japan and negatively by risk in Japan only. The study observed that industry effect was also significant in both Australia and Japan, which indicates the importance of the industry in which a firm competes.

Odawo (2015) did a study on dividend policy in public ltd banks in Kenya and adopted a descriptive research design and analysed data quantitatively and qualitatively. The results showed that the liquidity was negatively related to dividend payout while profitability was positively related to dividend payout. Also firm size is positively and significant with dividend payout

The effect of four factors shown to influence dividend policy among companies operating in developing countries using a Tobit regression model, it is observed that dividend payout ratio is impacted negatively by the growth rate, debt ratios and firm size and positively by earnings, market to book ratio and retained earnings to total asset ratio. The data consists of both cross sectional and time series information; it does not contain equal information in all banks in the sample for the entire period.

Therefore, in this study unbalanced panel estimation techniques will be used. Panel techniques takes into account the heterogeneity present among individual banks and allow the study of the impact of all factors with less collinearity among variables, more degree of freedom and greater efficiency.

RESULTS AND DISCUSSIONS

The above cited literature shows that the following are major determinants of dividend policy:

LEVERAGE

High debt means that firms have high interest expense which will lead to a low net income and thus fewer earnings will be available to shareholders. High leveraged firms means a large fixed payment for external financing, which indeed is a substitute for the dividend payment. High leverage increases transaction costs and the risk of the firm.

FIRM SIZE

The higher the level of asymmetric information that can be shown due to smaller firm size the higher the probability of underinvestment so the lower the dividend payment. Smaller firms would want to disburse more dividends to catch the attention of potential investors to lessen their inherent risk. As a firm grows in size they mature, have access to financial market and become less dependent on internally generated funds which allow them to pay higher dividends. Large firms pay higher cash dividends for several reasons. First, large firms face high agency costs as a result of ownership dispersion. Second, as a result of weak control in monitoring the management in large firms, a large dividend payment increases the need for external financing which in turn leads to increased monitoring of these firms by creditors. Third, large firms have easier access to capital markets and they are able to raise funds with lower issuance costs for external financing, consequently large firms are better placed to distribute higher dividends to shareholders than smaller firms.

BUSINESS RISK

Higher levels of business risk make the relationship between current and expected future profitability less certain. Firms with higher levels of business risk are expected to have lower dividend payment. The uncertainty of a firm's earning may lead to the payment of lower dividends because volatile earnings materially increase risk of default. Al-Kuwari (2009) Business risk appeared to be statistically insignificant. These suggests that the transactions costs do not have a direct influence on the dividend payout policy. (Amidu,2006) concluded that beta has a negative association with dividend payment greater systematic risk increased the uncertainty of expected future earnings. Therefore, firms force to pay fewer dividends due to increased uncertainty of earnings.

CONCLUSION

From the review of the literature, it has been observed that there exists no general agreement on the set of factors influencing the dividend policy. Different authors have used different combinations of the variables to explain the dividend behavior. Besides, there are different approaches to the decision involving the distributing versus, the retention of the net profit after the taxes. Again, the factors influencing the corporate dividend policy may vary substantially from country to country because of the inconsistency or, the variation in legal, the tax and the accounting policy among the countries. In view of these facts, the present study aims at identifying the factors/ variables significantly that influence the dividend policy in Kenyan banks.

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