

THE DIVIDEND PAYOUT POLICY – A COMPARISON ON MALAYSIAN ISLAMIC AND CONVENTIONAL FINANCIAL INSTITUTIONS

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ABSTRACT

The purpose of this study is to identify the determinants of dividend policy in the Malaysian Financial Institutions by looking at both conventional and Islamic banking sectors. Panel data set was constructed from financial institutions in Malaysia. The results show statistically significant positive relationship between dividend payout and revenue growth for conventional Malaysian Financial Institutions, i.e. conventional banks distribute higher dividends when they record higher profitability. On the other hand, only lagged dividend shows positive significant relationship with dividend payout for Islamic financial institutions in Malaysia. The results suggests that Islamic banks in Malaysia only look to the past dividend payment to determine their future dividend payments.

Keyword: Dividend policy, Islamic banking, panel data, Malaysia

INTRODUCTION

The current global financial crisis has not only caused doubt in conventional “Western” banking, but it also raises attention in Islamic banking. Policy makers and academicians address the advantages of Shariah-compliance financial products, in which, mismatch of short-term, on-sight demandable deposits contracts with long-term uncertain loan contracts are alleviated with equity elements (Beck *et al.* 2010).

Islamic banking turns into practical reality and starts functioning as early as 1970s. Since then it has been expanding and growing continuously, not only in muslim countries, but all over the world. It is positively astonishing to see that global conventional banks like Standard Chartered Bank, Deutsche Bank, HSBC, Citibank, *etc.*, set up separate divisions to integrate Islamic financial products and offer Islamic financial services to their customers who are interested in Islamic financial instruments. Many countries like France, China, UK, Singapore and others have established special regulations to spur the operation of Islamic banking.

The differences between conventional and Islamic banking system have dragged interest of many researchers to conduct comparative studies, for example, Zeitun (2012). Bashir & Hassan (2004) have studied the determinants of Islamic banking profitability from the year 1994 to 2001 for 21 countries. Their results exhibit that Islamic banks have a better capital asset ratios compared to conventional banks. In other words, Islamic banks are better capitalized. In another study, Bashir (2000)’s study shows that inflation does not have any impact on Islamic banks profitability whereas conventional banks perform otherwise.

From a theoretical perspective, Islamic banking differs from the conventional banking, mainly, because interest (*riba*) is disallowed in Islam (Yahya *et al.* 2013). For instance, Islamic banks are not allowed to take interest on deposits and prohibited from charging interest on loans. Islamic banking adopts profit and loss sharing (PLS) exemplification, which is initially based on *mudharabah* (profit sharing) and *musyarakah* (joint ventures) concepts of Islamic contracting. Under the PLS, the assets and liabilities are integrated in the sense that borrowers share profits and losses with the banks, which in turn share profits and losses with the depositors (Chong & Liu, 2009).

LITERATURE REVIEW

Dividend policy is vital for both managers and investors because it acts, not only as a source of income for investors, but it also reflects the firm's performance. Choosing a suitable dividend policy for the firm is an important decision for managers, as well as, investors. Academicians have proposed many theoretical and empirical models describing the factors the managers should take into consideration when making dividend payout.

Public companies tend to allocate the earnings of the fiscal year to be distributed to the investors in term of dividend. The policy of dividend distribution determines the proportion of the profits to be paid out as a return for investors and the portion to be retained for future investment by increasing the company capital (Huda & Farah, 2011). Their decision depends on the current and future performances of the company. It also relies on the preferences of current and potential investors.

The debate over the importance of dividend policy was first proposed by Miller & Modigliani (1961), who claim that in a world of perfect capital market, the payment of dividend have no significant effect on the firm's value and thus dividend remains beside the point. In such world, the values of the firms rely only on the distribution of future cash flow as a result of investments undertaking.

To come to term in a world with market imperfections, academicians have developed theories to justify reasons for firms to make dividend payment. For instance, Baker & Powell (2000) dispute that:

'[...] Mature companies with highly stable cash flow, paying little in dividend could lead managers to invest extra cash flow in projects or acquisitions with insufficient net present value. Yet, for firms with high growth rates likely distributing too much in cash dividend may reduce the firms' financial capabilities and cause them to refuse valuable investment opportunities. Either of those conditions could negatively affect firms' value over time. Therefore, it can be concluded that dividend payment is critical decision for firms.'

Dividend provides a glance of firm's performance for the investors as well as the capital market. It is because the firm's share price partially depends on the dividend payment's pattern (Huda & Fara, 2011). Traditionally, finance researchers emphasize elaborations for dividend that are based on the desire to communicate information to shareholders (Allen & Michaely, 2003). In addition, dividend distribution implies the growth and stability of a firm. The higher the dividend payment, the higher the assurance investors will have toward the pertinent firm.

Theoretical Considerations of Dividend Policy

A lot of theories have been developed on dividend policy. Some of these are bird-in-hand theory, signaling theory, bankruptcy theory, agency theory and Clientele theory. The bird-in-hand theory disputes that due to the uncertainty of the future cash flow; investors will prefer cash dividend than the retained earnings. Consequently, higher dividend payout ratio will reduce the required rate of return and has increased the firms' value (Lintner, 1962).

The signaling theory argues that share prices do not react directly to the dividend payout ratio itself. It reacts to the information that the investors perceived that changes in the dividend levels imply the future performances of the firms. Based on this assumption, managers are not eager to send the wrong signals to market. It is argued that the firms which anticipate increases in their net earnings would spread the information to the outsiders, whereas the firms which expect reductions in the cash flow would be unlikely to spread such information to the shareholders.

Al-Najjar & Hussainey (2009b) claim that general bankruptcy costs occur when firms face great difficulty in meeting its long-term debts. Consequently, the firm's ownership has to be changed and the capital structure is likely to be reformed. Some researchers discover that business risk toward bankruptcy costs is associated with the dividend policy of a particular firm (Ho, 2003 and Aivazian *et al.*, 2003). This theory can be tested by the firm's risk measured by firm's beta.

Another theory is the agency theory. The relation between shareholders and managers of the firms is the agency relationship. The shareholders of the firms are principals whereas the managers are the agents. Conflicts might occur between both parties. Empirical studies in support of agency explanation on dividend policy include Lloyd *et al.* (1985), Jensen, *et al.* (1992). The payment of dividend can be considered as a mean of reducing the amount of excess money available to managers which may not used appropriately for the interests of shareholders.

Clientele theory is another theory related to the dividend policy. This theory proposes that different clienteles prefer different dividend payout policies. For instance, some investors prefer firms that pay higher percentage from its net earnings as dividends, while others prefer otherwise. Also, if dividend income is taxed at a higher rate than

capital gains, investors in high tax bracket may prefer no dividend or low dividend paying stocks. Empirical studies that present evidence on the Clientele theory includes Petit (1977) and Dhaliwal *et al.* (1999).

Islamic Banking

Islamic banking is implemented in Malaysia following the enactment of Islamic Banking Act in April 1983 and the following establishment of its first Islamic bank, Bank Islam Malaysia Berhad (BIMB), in July 1983. The Islamic Banking Act of 1983 bestows Bank Negara Malaysia (BNM), the central bank of Malaysia, with the authority to regulate and supervise Islamic banks. At the end of 2004, there are 29 Islamic financial institutions and banks operating in Malaysia, which offer a full range of Islamic banking products and services (Chong & Liu, 2009).

Determinants of Dividend Policy

Baker & Powell (2000) investigate the views of corporate managers of major US firms about the factors influencing dividend policy in 1997. Their respondents include 198 responses from manufacturers, and wholesale/retail trades and utilities firms. They find that the major determinants of a firm's dividend policy are the level of current and expected future earnings and the pattern or continuity of past dividends. Debt ratio is also considered as one of the factors which affect the dividend payment. The study by Jensen *et al.*, (1992); Aivazian *et al.*, (2003) emphasize that a firm with a low debt ratio is more likely to pay dividend. This fact is related to agency cost as the firm needs to distribute dividend as debt is reported in company's financial statement. (Al-Najjar & Hussainey, 2009a).

Higher growth opportunity indicates more cash is required for expansion (Chang & Rhee 1990). This leads to earnings being retained, rather than dividend distribution. Ahmed & Javid (2009) explore the determinants of dividend policy in Pakistan. They find that the market liquidity and ownership concentration have positive impact on dividend payout policy. On the other hand, the investment opportunities and financial leverages have negative impact on dividend payout policy. Mahapatra & Sahu (1993) find that the capital structure of a firm is negatively correlated with the dividend payment.

Profitability

A positive relationship between dividend policy and profitability is expected (Lintner 1962). Logically, profitable firms would pay more dividends since dividend is derived from annual profits. In order to find out whether the profitability of a firm influences its dividend payout, return on assets (ROA) is used as a measure for profitability.

Shirvani & Wilbratte (1997) identify three determinants that measure the ability of a firm to pay dividend, namely: current earnings, cash flows and stock prices. Their result supports the Lintner's model. Furthermore, the study finds that current earnings are better at explaining long-run dividend when compared to cash.

An important determinant of dividend payment is the current earnings (profit after tax), which symbolizes the propensity to distribute dividend, has a positive correlation with dividend payment. Firms which are more profitable tend to pay higher dividend than those which are less profitable.

Liquidity/ cash flow

Brittian (1966) argues that cash flows would be more important than net earnings in determining a firm's capacity to make dividend payment. Cash flow is considered the relevant measure of a firm's disposable income. Liquidity ratio is used as a proxy to examine the relationship between dividend policy and cash flow. This variable is expected to positively correlate with dividend payment.

Hassan (1999) analyzes the information of the 100 companies listed on Karachi Stock Exchange using the least squares regression model. As a result, he finds out that there is positive relationship between the operating cash flow and profitability and stock dividend. Thanatawee (2011) studies the dividend policy of Thai listed companies over the period 2002-2008. He highlights that larger and more profitable firms, with higher free cash flows and retained earnings to equity, are more likely to pay higher dividend.

Stability of dividend

Lintner (1962) observes that most managers are unwilling to reduce the dividend payment because they feel that if they were to do so, they would hurt their companies' stock prices. Managers believe that investors are willing to pay more for dividend stability. Therefore, managers are keen to meet investors' expectations. The stability of the dividend policy provides assurance to the investors on the performance of a particular firm; hence, the investors are willing to pay a premium for dividend stability and this would boost the stock price. Apart from that, Lintner (1962) also discovers that managers tend to be very conservative when it comes to revising the dividend policy. In other words, managers would change the dividend policy when they are absolutely sure that they are able to sustain the dividend change that is being made.

Financial leverage

Gugler & Yurtoglu (2003) and Aivazian *et al.*, (2006) report a negative relationship between dividend payment and leverage. Therefore, this study anticipates negative relationship between these two variables. Debt ratio (liabilities divided by total assets, measured in book-value term) is used as a proxy for leverage.

Rozeff (1982) points out that beta coefficient, which symbolizes the volatility of the firms' earnings compared to the market, is lead by the financial and operating leverage of the firms. When beta is higher, the dividend payout tends to be lowered as the firms are responsible to make fixed payments to cover the leverage.

For a certain extent, a high amount of debt is legally restricting the dividend distribution of the firms. It is also normal for banks with higher leverage ratio to be under larger regulatory pressures. Thus, they are restricted to pay higher dividend (Dickens *et al.*, 2002). DeAngelo & DeAngelo (1990) find that more than half of their sample of firms from NYSE face binding covenants in the years that they reduced their dividend payments. Crutchley & Hansen (1989) empirically discover that dividend is negatively correlated with firms' leverage.

Debt obligations and interest payments reduce the ability of firms to have residual income to guarantee dividend payment. Consequently, it is expected that debt would impact negatively on the amount of dividend paid for a period. Kowaleski *et al* (2007) argue that more firms are highly obliged prefer to pay lower dividend.

Agency and transaction cost

Rozeff (1982) tries to explain the wide variations between U.S firms in their dividend policy. According to him, agency cost is derived from the assumption that management can misuse the free cash flow for their interests and, thereby should be ploughed back to investors through dividend distribution. On the other hand, transaction cost occurs when management is overly generous when determining the dividend payout. This may result in the firm to be constantly requiring debt or equity financing. This could increase the associated transaction cost, which has a negative impact on the value of the firms. It has been argued that the firms might use dividend to reduce the agency problem between managers and shareholders (Jensen, 1986).

Schooley & Barney Jr (1994) propose the result of managerial ownership is expected to minimize the agency cost by paying high dividend. Their study discovers a relationship between managerial ownership and dividend yield. This finding is the opposite of the study by Rozeff (1982), which indicates that insider's ownership is positively correlated with dividend. This result points out that the managerial ownership lessens the agency cost and dividend yield.

Revenue growth

Based on Rozeff (1982) assumption, higher growth rate in revenue is positively related with higher investment expenditure. Firms are most probably investing the excess of their revenues. However, it is expected that dividend payout is negatively correlated with higher growth rate of revenues. This is due to cash being required to sustain the higher growth rate in revenues. If not, the firms will be exposed to higher transaction costs of raising additional funds to support the dividend payment.

Chen & Dhiensiri (2009) conclude that firms that experience recent rapid growth in their revenues tend to lower their dividend payment. For firms that are growing rapidly, there will be an increase demand of capital. Many theories conclude that firms should prioritize financing their new projects with retained earnings. As a result, firms

with greater growing opportunities will likely to retain a large portion of their earnings to finance their expansion projects rather than distribute the earnings to their investors.

According to the findings of Chen & Dhiensiri (2009), firms which are experiencing rapid growth in revenues tend to reduce their dividend payment. It can be similarly explained that those firms are likely to finance their new projects or investments rather than distribute the growth to the investors. Therefore, revenue growth is negatively correlated with dividend payment.

Lagged dividend

Lagged dividend refers to the cash dividend paid by the firm to the investors prior to the year under consideration (Pal & Goyal 2007). Past dividend trend is significant enough to influence the current dividend payment in order for management to follow a stable dividend policy. This variable has been included as an important determinant in most of the theoretical and empirical studies.

Pruitt & Gitman (1991) find that lagged dividend has a positive relationship with dividend payout as most of the firms would like to maintain a stable dividend payment. The fundamental indicator of a firm's capacity to pay dividends is previous dividend payment as it is assumed that management would more likely to maintain a stable dividend policy (Lintner 1956).

METHODOLOGY

In this analysis, panel data regression method is used. Assuming a linear relationship between dividend and its determinants, the regression model can be outlined as:

$$DIVIDEND_{it} = \beta_0 + \beta_1 PAT_{it} + \beta_2 LAGDIV_{it} + \beta_3 REV_{it} + \beta_4 LEVERAGE_{it} + \beta_5 CASHFLOW_{it} + \mu \dots \dots \dots 1)$$

Where:

$DIVIDEND_{it}$ = Dividends in time t

PAT_{it} = Profit after tax in time t

$LAGDIV_{it}$ = Dividends in time t-1

$CASHFLOW_{it}$ = Cash flow in time t

REV_{it} = Revenue Growth in time t

$LEVERAGE_{it}$ = Financial leverage in time t

μ = Random disturbance term and

β = Regression coefficient

Proxy of Measures for Variables

Dependent variable

The dependent variable is measured by using dividend per share (DPS) ratio. DPS is the ratio of dividend payment over number of shares for bank i in time t :

$$\text{Dividend per Share} = \text{Dividend payment/Number of shares}$$

Independent Variables

- 1) Profitability is measured by net income divided by total assets equal to the return on assets (*i.e.* ROA).

$$\text{Profitability (ROA Ratio)} = \text{Net Income/Total Assets}$$

- 2) Financial leverage is measured by the ratio of total debts over total assets (measure in book value term) for bank i at time t :

$$\text{Financial Leverage} = \text{Total Debts/Total Assets}$$

- 3) Cash flow or liquidity is the ratio of cash and cash equivalent over net total assets for bank i in time t :

Cash Flow/ Liquidity = Cash and Cash Equivalent/Net Total Assets

- 4) Lagged dividend is equal to the dividend paid last year (Div_{t-1})
- 5) Revenue growth measures how much the growth in current year's revenue compared to last year's revenue.

Revenue Growth = (Revenue of Current Year – Revenue of Last Year)/Revenue of Last Year

Sample Selection

The pertinent data is taken from the Malaysia banking industry for the period of ten years, from 2001 to 2010. In total, there are 142 banks and financial institutions operating in Malaysia. They are varying in sizes, bank structures and backgrounds. However, this study will only focus on 17 Islamic banks and 48 conventional banks in Malaysia due to data availability.

Data Analysis

The data collected is analyzed by using E-Views and RATS software to identify the determinants of dividend policy among conventional and Islamic banks in Malaysia.

Multiple regression result

Table 1: Panel regression among conventional banks

Panel Regression - Estimation by Random Effects

Variable	Coefficient	Std. Error	T-Statistic	Signif
LEVERAGE	-0.02069	0.299303	-0.06913	0.9451
ROA	-7.40375	7.130904	-1.03826	0.3029
LAG_DIV	0.175529	0.123617	1.419943	0.1603
REVENUE_GROWTH	0.202258	0.081544	2.480367	0.0157*
LIQUIDITY	6.25E-06	5.49E-06	1.145761	0.256

From table 1, only revenue growth is significant at 5%. Therefore, only revenue growth is significantly and positively related to dividend payment.

Table 2: Panel regression among Islamic banks

Panel Regression - Estimation by Random Effects

Variable	Coefficient	Std. Error	T-Statistic	Signif
LEVERAGE	-0.0240	0.0502	0.47828	0.63244810
ROA	0.0766	0.1833	0.41807	0.63244810
LAG_DIV	-0.4967	0.0753	-6.59440	0.0000000*
REVENUE_GROWTH	4.7735e-04	1.3371e-03	0.35701	0.72108193
LIQUIDITY	4.855e-07	2.0508e-06	0.23676	0.81284358

The random effect model is more appropriate in explaining the relationship between the dependent and independent variables. From table 2, only lagged dividend is significant at 5% and has positive and significant relationship to dividend payment.

CONCLUSION

This study is conducted to investigate the determinants of dividend policy for Islamic and conventional banks in Malaysia. In this analysis, a sample of 26 banks was selected from Bank Scope. This sample consists of 18 conventional and 8 Islamic banks. Dividend per share is employed as dependent variable while ROA, liquidity, lagged dividend, revenue growth and leverage are considered as independent variables in this research.

The results of this research show that for conventional banks, revenue growth is significantly and positively related to dividend payment. Thus, it can be said that conventional banks which are experiencing stable and satisfactory revenue growth rate tend to pay higher dividend. For Islamic banks, only lagged dividend has significant positive relationship to dividend per share. Therefore, majority of the Islamic banks will pay dividend based on the dividend they paid last year. This shows a consistency in the dividend payment.

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