

Determining dividend payouts of the Indian banking industry

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Abstract: Dividend policy is a critical aspect of corporate financial management, representing a balance between retaining earnings for future growth and distributing profits to shareholders as dividends. This study investigates the impact of dividend payout ratios on wealth creation, with a particular focus on the banking sector. As one of the most pivotal components of the financial system, banks not only act as intermediaries of capital but also serve as key drivers of economic development. Their financial decisions, including dividend policies, significantly influence investor confidence and wealth accumulation. The primary objective of this research is to examine the relationship between dividend payout ratios and wealth creation among selected banking companies, and how these financial practices shape shareholder value in the context of the Indian banking sector.

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Introduction:

The term dividend refers to that part of the profits of a company which is distributed amongst its shareholders. It may therefore be defined as the return that a share-holder gets from the company, out of its profits, on his shareholding. "According to the institute of chartered accounts of India" Dividend is a "Distribution to shareholder out of profits or reserves available for this purpose". The dividend policy has the effect of dividing its net earnings into two parts; Retained earnings and dividend. The retained earnings provide funds to finance the long- Earn Growth. It is the most significant source of financing a firm's investment in practice. A firm, which intends to pay dividends and also needs funds to finance its investment opportunities, will have to use external sources of finance dividend policy of the firm. Thus has its effect on both the long term financing and the wealth of Shareholders. The moderate view, which asserts that because of the information value of dividends, some dividends should be paid as it may have favorable affect on the value of the share. A reserve may be defined as the sum set aside out of divisible profits and retained earnings in order to provide for unexpected or unknown future losses, or to equalize dividends or to strengthen the financial position of the company.¹ In other words, it is a surplus created out of distributable profits representing the amount by which the assets of a concern exceed the sum of its paid up capital and liabilities properly valued on the basis of going concern.² The various kinds of reserves are as follows: surplus from reduction in par value of stock, surplus from revaluation of assets, surplus from sale of assets, accumulation of profits and surplus from

issue of share at premium. These surpluses account for the equity of the owners over and above the capital stock³. Parts of these surpluses are earmarked for specific purposes. Conservative management often dictates that at least some of the surplus of a company should be ear-marked as not available for dividends. It may be because of: (a) contractual obligation which the company is preparing to meet; (b) the source of surplus makes it not available for dividends; (c) it is desirable to provide a buffer against future losses and declines in the assets values; and (d) to provide for future expansion. A wise policy on the part of the management is not to distribute all the earnings of the company but to retain a part of it before declaring dividend. These retained earnings are in the form of reserves.^{4,5}

Depreciation policy

Well-managed companies in India make regular provision of income to restore impairment in the value of their physical assets.⁶ This impairment in serviceability of an asset is known as depreciation.⁷ It is an allowance made for loss or diminution in the value of an asset generally on account of wear or tear. Depreciation policy has a bearing on the measurement of a firm's income; it practically affects all the important corporate matters. Depreciation is a non-cash item and this 'tax free loan' upto the time of replacement of assets, remains at the disposal of the management to be used in any manner as they deem appropriate.⁸ Thus, the amount of external funds needed by the firm for growth also depends upon the depreciation policy of the firm. Depreciation policy affects investment decisions in two ways. Firstly, a rupee reported as depreciation, as compared to a rupee reported as taxable business income is worth several rupees because it avoids double erosion.⁹ As

a capital recovery, it is tax free. Because it is a recovery of investment reduces the risk of such investment and creates greater assurance. Depreciation policy is a matter of considerable importance because of its relationship to replacement policy.¹⁰ Depreciation provisions increase the firm's working capital as the structural position of the assets is changed converting fixed assets (loss of depreciation) to current assets. These depreciation recoveries, in the short run are at the disposal of the financial manager to be used as he deems most appropriate. But, in the long- run they meant to replace the assets.¹¹ Secondly, the primary purpose of a business is to make profits for its owners and to distribute it in the forms of dividends. A business which does not earn profit to compensate the owners for the risks incurred is to be an economic failure.¹² Company profits are reward that accrues to the shareholders for their contribution of risk capital.¹³ The reward distributed among the shareholders in the form of dividend risk that should include a normal rate of interest plus a return for the risk assumed.¹⁴ In economic principle, dividend is the right of shareholders to participate in the profits and surplus of the company in whose capital they have equity. Dividend also is an aspect of corporation policy towards the management of profits. It is at the discretion of the Board of Directors that the disposal of profits is decided upon. They may distribute all the current profits or past profits or set apart a part of profits for reserves and distribute the balance in the form of dividends. Broadly speaking, the regularity and adequacy of earnings, the attitude of shareholders, the availability of cash balances and future requirements of the capital for the company are the basic principles governing the dividend policy.^{14,15,16} The basic aim of every company is establishing a stable dividend policy consistent with the interest of the company and shareholders. Stable and progressive dividend policy keeps up the moral of the shareholders by duly compensating them for the capital they have risked.¹⁷ It would ensure their unlimited co-operation in implementing other policies of the company. Regularity of dividend payment out of the normal earnings maintains and enhances the market value of the securities^{18,19}.

Review of Literature:

Dividend is a critical finance function as it involves determination of amount to be distributed to shareholders. The amount to be distributed depends on so many factors and liquidity is one of them. A study carried out over the corporate dividend policy of Islamic banks helped to conclude that liquidity had a significant relationship with the dividend payout ratio (Ahmed, 2015). Another study on the dividend policies of the Indian companies found that liquidity

had a significant impact on the dividend payout determination (Labhane & Mahakud, 2016). Past studies on the dividend policies of banks in Pakistan (Zamir et. al., 2013) and public and private commercial banks in India (Devanadhen & Karthik 2015) found that Liquidity was having a negative impact on dividend payout. Similarly a study on the FMCG sector organizations found that liquidity bears a significant negative relationship with dividend payout (Kapoor et. al., 2010). An analysis carried out with regard to corporate dividend policy was helpful to conclude that one of the most important factors found responsible for increasing rate of dividend is the enhanced liquidity position of an organization. It was further found in the study that liquidity was having a significant impact on dividend payment decisions as compared to other factors (Sarvanakumar 2011). Another study conducted over the dividend policies of the Indian corporates found that liquidity was strongly positively associated with the dividend rates of Indian companies (Gupta & Banga, 2010). However, in a study of dividend disbursement practices of commercial banks it was reported that the liquidity coefficient does not have a high effect over dividend disbursement (Gupta & Walker, 1975). In a study conducted with regard to the corporate dividend policy of Indian banks it was concluded that sales was one of the most important factors found responsible for increasing rate of dividend. It was also found that sales were having a significant impact on dividend payment decisions alongwith some other factors (Sarvanakumar, 2011). Sales was found to have a positive impact in four sectors and negative impact for three sectors as evidenced in a study conducted for a sectoral analysis of companies registered at the Karachi stock exchange (Khan & Shamim, 2017). Another study conducted over the dividend policy of Indian banks remarked that the volume of sales was having a positive influence on the dividend policy of banks however, it was usually when there had been a negligible decline in debt irrespective of trivial increase in dividend tax rate (Sudhakar & Saroja, 2010) . However, in a study of listed IT companies at the BSE it was found that change in sales in the preceding two years has an insignificant impact over dividend policy (Kumar & Jha, 2012).

Materials and methods:

To examine the various hypotheses, the study has used secondary data. The sample was drawn from the companies listed of Seoni, Madhya Pradesh (India). Multiple Regression Model

In order to establish the relationship between company characteristic and Dividend policy multiple regression model has been used wherein dividend payment has been used as dependent variable and

company characteristics as operating profit (EBIT), debt equity ratio, company size (measured by market capitalization), growth opportunity (in terms of total

$$DIV_{it} = \beta_0 + \beta_1 EBIT_{it} + \beta_2 DE_{it} + \beta_3 IP_{it} + \beta_4 CS_{it} + \beta_5 GTA_{it} + \beta_6 CR_{it} + \beta_7 LD_{it} + \epsilon$$

assets), interest paid, current ratio and lagged dividend have been considered as independent variables. Mathematically,

Where;

EBIT= Operating profit, DE= Debt Equity Ratio, IP= Interest Paid, CS= Company Size, GTA= Growth Rate in Total Assets, CR= Current Ratio (Short term Liquidity) and LD= Legged Dividend .

Results:

Table 1 displayed that in case of Banking Industry interest payment and lagged dividend were the most important determinants of dividend payment as the regression coefficients of these variables have the highest values during most of the years and were found statistically significant for six and seven years respectively. The regression coefficients of interest payment have negative values during most of the years under study, which suggests that there was a negative relationship between dividend payment and interest paid. It means companies having more interest burden, tends to pay less dividend. Similarly in case of lagged dividend, the regression coefficients as positive values during most of the years under study, which suggests that there was a positive relationship between lagged dividend and current dividend payment, which supports the hypothesis. Likewise, in case of operating profit and company size the regression coefficients of operating profit have positive values during most of the years and were found statistically significant for one year out of total years under study (Table 1).

The analysis suggests that there was a positive relationship between current dividends paid and lagged dividend, which supports the hypothesis. The The coefficients of determinant r^2 which range between 0.39 to 0.99 indicate that the independent variables have been causing more than seventy per cent of the variation in the dividend paid by the companies belonging to Banking Industry. F values also indicate that independent variables are the important determinants of current year's dividend paid. The Durbin Watson test which has been applied to examine the existence of autocorrelation in the cross sectional data series, reveals the absence of autocorrelation in each year of the study as its values are near 2. Hence, the results of the model give reliable estimates (Table 1).

All this tends to confirm that interest payment and lagged dividend were the most important determinants followed by operating profit, company size, current ratio, debt equity ratio and growth rate in total assets in the Banking Industry (Table 1).

Conclusion: Financial management encompasses a broad spectrum of activities aimed at optimizing the

regression coefficients of company size have positive signs during most of the years, which suggests that there is a positive relationship between company size and dividend payment, which again supports the hypothesis. It means companies larger in size pay more dividend than the smaller ones. The regression coefficients of current ratio show a negative value during most of the years, which suggests that there was a negative relationship between dividend paid and short term liquidity which was contrary to the hypothesis. The regression coefficients of debt equity ratio have negative values during most of the years and were found statistically significant for four years out of sixteen years of study. This suggests that there is a negative relationship between dividend paid and debt equity ratio, which supports the hypothesis. It means that levered firms tend to pay fewer dividends than the unlevered ones. The regression coefficients of growth rate in total assets have negative values during most of the years of study, which suggests that there was a negative relationship between growth rate of assets and dividend payment, which again supports the hypothesis. It means that companies having more internal investment opportunity tend to pay fewer dividends and favour the retained earnings as a source of funds for investing purpose (Table 1).

financial performance and value creation of a company. One of its primary objectives is to maximize both profitability and shareholder wealth. While profitability reflects the company's capacity to produce revenue, shareholder wealth represents the value accrued to shareholders through various means, including dividends, capital appreciation, and overall company performance. Dividend decisions are integral to financial management as they directly impact both the company and its shareholders. These decisions involve determining the amount and frequency of dividends to be distributed to shareholders, as well as the overall dividend policy to be adopted by the company. The choice of dividend policy, whether it's a stable dividend policy, residual dividend policy, or other variants, reflects the company's strategic approach to balancing the interests of shareholders with its operational and investment needs. For investors, dividend decisions carry significant weight in their decisionmaking process. The type and consistency of dividends

offered by a company can signal its financial health, stability, and growth prospects. Shareholders often evaluate dividend-paying companies favorably, as regular dividend income provides a steady stream of returns and contributes to portfolio stability. Additionally, dividend policies can influence investor perceptions of a company's management quality and commitment to shareholder value maximization. Companies, in turn, base their dividend decisions on various factors, including their financial performance, cash flow position, growth opportunities, and capital allocation priorities. Dividends are typically

distributed to shareholders as a reward for their investment in the company and as a means of sharing profits. However, companies may also consider retaining earnings for future growth initiatives, such as research and development, expansion into new markets, or acquisitions. In the context of the banking sector in India, dividend decisions play a crucial role in shaping investor confidence and market dynamics. Publicly listed banking companies on the National Stock Exchange (NSE) are subject to regulatory requirements and market expectations regarding dividend payments.

Table 1: Company characteristics and Dividend Payments in Banking Industry

	Regression Coefficients							Model summary			
YEAR	EBIT	DE	IP	CS	GTA	CR	LD	R ²	DW [@]	F	SIG
2008	0.54 (2.47)	-0.03 (-0.24)	-0.88 (2.61)	0.23 (-1.03)	-0.10 (-0.1)	0.11 (0.59)	0.48 (-2.0)	0.99	2.11	22.11	0.044
2009	-0.20 (-0.38)	0.03 (0.12)	0.24 (0.39)	0.11 (0.28)	-0.35 (2.10)	-0.17 (-1.11)	0.73 (0.89)	0.99	2.66	14.84	0.197
2010	0.010 (-0.10)	0.010 (0.31)	-1.00 (38.9)*	-0.21 (-0.48)	0.03 (1.52)	-0.01 (-0.86)	0.01 (0.21)	1.00	1.98	717.4	0.000
2011	0.01 (0.07)	0.18 (1.89)	-1.08 (3.25)	-0.03 (-0.19)	0.04 (0.41)	-0.09 (-0.91)	-0.19 (-0.62)	0.90	1.75	17.99	0.000
2012	0.08 (0.72)	-0.02 (-0.37)	-0.28 (2.32)**	0.01 (0.20)	-0.02 (-0.40)	0.07 (1.72)	1.25 (11.37)*	0.98	1.52	114.6	0.000
2015	0.05 (0.12)	0.09 (1.04)	0.02 (0.14)	0.07 (0.69)	0.010 (0.02)	-0.04 (-0.52)	0.86 (5.60)*	0.93	1.88	36.03	0.000
2014	0.11 (0.56)	-0.47 (-1.51)	-0.26 (0.49)	-0.52 (-1.57)	0.02 (0.11)	0.39 (1.95)	0.80 (1.43)	0.39	1.34	1.75	0.157
2015	0.03 (0.41)	-0.07 (-1.11)	0.03 (0.26)	-0.02 (-0.24)	0.07 (1.10)	0.08 (1.37)	0.94 (14.34)*	0.94	1.37	41.49	0.000
2016	-0.05 (-0.70)	-0.17 (2.16)**	-0.76 (5.48)*	0.14 (1.12)	-0.10 (1.25)	-0.01 (-0.11)	0.24 (3.14)*	0.90	2.18	28.89	0.000
2017	0.04 (0.51)	-0.53 (4.99)*	0.28 (1.18)	0.12 (-0.77)	-0.05 (-0.61)	0.09 (1.13)	0.57 (3.09)*	0.91	1.64	28.97	0.000

2018	-0.05 (-0.64)	-0.06 (-0.36)	-0.82 (2.11)**	-0.06 (-0.16)	-0.11 (1.05)	-0.10 (-1.03)	0.23 (1.11)	0.88	1.40	19.46	0.000
2019	0.02 (0.35)	-0.09 (-1.12)	-0.64 (1.57)	-0.08 (-0.23)	0.010 (0.03)	-0.04 (-0.48)	0.41 (2.17)**	0.92	1.59	29.27	0.000
2020	-0.03 (-0.42)	0.010 (-0.02)	0.44 (0.88)	-0.02 (-0.06)	-0.01 (-0.14)	-0.03 (-0.44)	0.55 (2.51)**	0.92	1.81	29.80	0.000
2021	0.01 (0.17)	-0.17 (2.24)**	-0.88 (2.91)*	0.08 (0.38)	0.07 (0.93)	-0.05 (-0.75)	0.03 (0.14)	0.94	1.48	34.80	0.000
2022	0.11 (-0.84)	-0.38 (2.58)**	-1.85 (2.78)**	0.22 (-0.37)	0.15 (1.28)	-0.05 (-0.43)	-0.65 (-1.85)	0.89	1.55	15.18	0.000
2023	0.19 (2.53)**	-0.24 (4.53)*	-0.53 (1.79)	0.28 (1.00)	-0.01 (-0.12)	-0.10 (-1.91)	0.11 (1.05)	0.98	2.38	93.38	0.000

*&** Statistically significant at 1% and 5% Respectively (Values in Brackets are t values)

@DW= Durbin Watson test, Source: Prowess Database (CMIE)

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