Dividend Policy and Corporate Governance of Financial Sector

By

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List of Abbreviations

BSIZE .... *Board Size*

NEX .... *Non-Executive Directors*

BLOCK .... *Block Holders*

FCASH .... *Free Cash Flow per Share*

PRO .... *Profitability*

GRO .... *Growth Opportunity*

LEVRG .... *Leverage*

ISDUMMY .... *Islamic Bank Dummy*

PDUMMY .... *Privatized Dummy*

GDUMMY .... *Government dummy*

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Abstract

The research study investigates the impact of corporate governance on the dividend policy of banks in Pakistan. The increased incidence of bank failure in the recent period generated the current debate on disclosure of financial information and transparency to the different users, as results of appraising good governance in banks. This study use secondary data in ensuring that data obtained are sufficient for a rational conclusion. The secondary data obtained from the annual financial statement of the banks for a period of seven 2006-2012 accounting year are used in analyzing the financial ratios and corporate governance mechanism for the study. *The pooled dummy variable analysis estimation technique* is used in this study. The study concludes that corporate governance significantly contributes to positive association with the dividend policy in the banking sector. It therefore recommends that corporate governance codes should be adapted to meet the need of Pakistani business environment.

Keywords: corporate governance, dividend policy and bank failure, pooled dummy variable

Chapter 1: Introduction

Corporate governance is defined by Cadbury (1992) as *"the system by which companies are directed and controlled"*. It is concerned with the duties of board of directors of the company to lead the successfully company and to build association with its stakeholders groups (Pass 2004).Corporate governance is also defined by (Rezaee, 2009) *"the procedure through which shareholders take management to act in their interests"*.

In general, corporate governance has significant implications for the growth prospects of an economy, because proper corporate governance practices attract investments capital, reduce risk for investors and improve performance of companies (Spanos, 2005). In Pakistan, effective corporate governance is considered as an enhancing the integrity and efficiency of capital markets (Rezaee, 2009).Corporate governance provides the process through which the objectives are set, provides proper means through which those objectives of companies are attained and monitoring the performance of company.

Corporate governance provides proper incentives for the management to attain the objectives that are in the interests of its shareholders and company. The system of corporate governance is to provide a degree of confidence that is very important for the interest of proper functioning of market economy (OECD principles 2004). Better corporate governance provides checks and equilibrium between shareholders and management to mitigate agency problems. Therefore firms with better corporate governance bear less agency conflicts (John and Senbet 1998, Jiraporn *et al* 2011). In such firms managers less likely to adopt a dividend policy.

Corporate governance in agency theory view is that the separation of ownership and control (Barle and Means 1992).There are two most common views that corporate governance to

save investor's right. First view is to give legal protection from expropriation by managers. Corporate governance gives protection of minority rights against managerial self-dealing. The second view is the ownership by large investors matching significant control right and cash flows. Larger investors are exercising their powers in world including large share holdings, relationship banking and takeovers.

1.1: Theoretical Background

The question is why companies pay dividend? Dividend policy is concerned with policies of company to pay cash dividend in the present or paying an increased dividend at a later stage. *Dividend is decided on the basis of company's profit (excess cash) and influenced by the company's long-term earning power*. Management is expected to pay dividend when cash is available in surplus. Probably dividend is used to mitigate agency problems that are existed in company up to some extent. According to Jensen (1986) agency problems are arise in companies when the shareholder's interest is get dividend and manager's interest is to retain earnings. The purpose behind to retain earning is for sustaining higher control over resources.

According to Jensen (1986) and Rozeff (1982), if managers do not pay dividend to the shareholders, they start using their possessions for their personal use. La Porta *et al* (2000) tell that as *the "agency model of dividends*" shows that the shareholders use their power to influence the company's dividend policy when the shareholders has greater rights on dividend policy. Shareholders can get their greater rights through legal protection of state and the standards of the governance policy. Dividend policy is not only used to reduce the agency cost but it is a big source to give information about the firm's financial position to the shareholders.

Corporate governance is used as a powerful tool to control the agency cost. Corporate governance affects the dividend payout policy of the firms. Corporate governance is a collection of laws, policies and processes which control an organization. The ultimate aim of the corporate governance is to improve the firm's performance and eliminate the agency cost. Corporate governance involves the regulatory bodies, board of directors, shareholders, auditors and management.

Corporate governance is considered as to put away the shareholders' right and have a great impact on the decision of dividend policy (Kowalewski *et al*., 2007; Bebczuk, 2005). Corporate governance control the managers due to good governance practices, due to this low free cash flow are available for managers to distribute among shareholders (John and Knyazeva, 1998). In this way, the both theoretical and empirical studies recommend an association between dividend policy and corporate governance characteristics.

All the investors make an investment in business for dividends and capital gains. The boards of directors take a strategic decision to pay dividends among the shareholders of the company. The dividend paying decision is one of the major unresolved issues in finance (Brealy and Myers 2004), and it becomes more critical when ownership is concentrated. In such situation, an agency conflict can arise between internal shareholders and external shareholders. For such situation, outsider shareholders desire the payment of dividends (Jensen 1986, Myers 2000).

In countries where legal protection is well-built, minority shareholders can use their rights to induce internal shareholders for payment of dividends. But in countries where legal protection is weak, outsider shareholders are unable to induce the management to pay dividend's

payment. La Porta (2000) confirm that in countries where legal protection for minority shareholders is well-built dividend payments are on the average higher in those countries. In this situation it becomes more important to know that what type of governance system is being used in the firms.

1.1.1: Corporate Governance and Banking Institutions

The need for a competent financial sector is important to stimulate and support economic growth through efficient resource allocation. The financial system also enhances growth by pooling risks and facilitating transactions (World Bank, 1989). The role of financial sector in economic growth is even greater in developing countries as their tolerable margin of errors in resource allocation is small. Different cross-country studies support the idea that countries with efficient and strong financial markets experience higher rates of economic growth. Some studies have also found the strong evidence of relationship between the size and operation of financial markets and/or the development and structure of banking sector and economic growth (King and Levine, 1993; Levine and Zervos, 1998; Rajan and Zingales, 1999; Cetorelli and Gambera, 2001). The number of bank failures and financial crises during the last two decades raises questions on the competency of the governance practices of the banking system.

Over the past two decades, financial sector in Pakistan has undergone a phenomenon changes. The transformation is taken place by introducing financial reforms in this country. These financial reforms play a significant role in the growth of this sector. *Privatization, restructuring of state owned banks, merger and acquisitions of private and foreign banks and introduction of Islamic banks have changed the governance structure of banking sector substantially.* Before these reforms, financial sector in Pakistan mainly considered as a government sector. More than 90 percent market share was owned by state owned banks. These

banks served as a tool to implement the government development strategy. In 1972, all commercial banks had been nationalized expect few foreign banks. These foreign banks could not expand their operations due to strong regulations. These banks were used to give credit to the preferred sectors of the economy and also loans were given on the political basis. Initially, the arrangement gave good results but it did not sustain longer. The inefficiency of the banking sector observed shortly due to bad and influential governance by the government authorities. The proportion of non- performing loans were increasing day by day which results in high default rates of state owned banks.

The situation was realized shortly and new financial reforms introduced by State Bank of Pakistan in early 1990. The objective of these reforms was to strengthen the financial institutions by adopting the liberalization policy in prudential regulations. The primary justification to introduce these reforms has been the potential to eliminate systematic sources of inefficiencies in the banking sector. Not only the inefficiencies but also to improve the governance structure of this sector.

In *First* part of these liberalizations and reforms, ten new private banks were permitted to start their operation in early 1990s. Apart from domestic private banks, three foreign banks were also permitted to start their operation in the same period. As a part of these reforms, the control on opening new bank branches by private and foreign banks was also lifted. At the same time, privatization of state owned banks also took place by selling 26 percent shares of Muslim Commercial Banks to the private sector, 50 percent to the general public and remaining 24 percent also sold in 2001-02. *Similarly, the privatization of ABL, UBL and HBL were also taken place.* Mass privatization of state owned banks led to their market share down to 20 percent in 2005 as compared to 70 percent in 1990.

Secondly, state owned banks had also undergone through huge structural changes and downsizing. A fund was provided by the World Bank to state owned bank for their restructuring and downsizing in 1997. A large number of employees were voluntarily resigned from the banks under the golden shake hand scheme. Also, number of branches of state owned banks which were not performing well was also closed down.

Finally, the governance of banking sector in Pakistan was influenced by merger and acquisitions of some private and foreign banks. New policy introduced by State Bank of Pakistan has also encouraged merger and acquisition of small and struggling private and foreign banks by their financially superior counterparts. As a result, in a period of five years from 2000–2005, 12 banks are merged and acquired out of which nine foreign banks are acquired by the domestic private banks.

During this period, Islamic banking are also introduced by private and foreign banks in Pakistan. Initially, few Islamic banks are operated with a very little market share. But in very short period of time Islamic banking assets reaches to 411 billion with a massive growth rate of 6.1 percent. The investors are willing to invest in Islamic Banks rather than the conventional banks due to its strong governance structure. Pakistan has adopted an unusual three-tier *Shari's-compliance* structure to ensure ―deep and extensive‖ supervision of *Shari's compliance*. The structure consists of the following components; (1) internal *Shari's* advisers for Islamic banks, (2) a national *Shari's-compliance* inspection unit, and (3) a national *Shari's* advisory board established by the State Bank of Pakistan, the central bank (Akhtar, 2006). The banking sector in Pakistan enjoyed healthy returns and achieved high growth after making necessary adjustment in their corporate governance structure. More liberal but concerned governance structure is established in this sector. No more political influence, corruption and unnecessary control of

government are there. This strong corporate governance structure protects the right of shareholder's which enhances the confidence of external investor.

1.1.2: Why Corporate Governance Matters For Banks in Pakistan

The need for corporate governance in Pakistan is unambiguous. The country has increasingly responded to the corporate governance challenges and progress in the banking sector is largely inspiring. Before we consider the corporate governance reforms for banks and the outstanding agenda, let us first investigate why corporate governance matters for the banking system.

Most importantly, the financial system in Pakistan continues to be mainly bank based. Good corporate governance for banks, therefore, becomes critical in ensuring solvency and stability of the financial system as effectively governed banks are more efficient and discreet in directing their resources. *Secondly*, banks are highly-leveraged: they lend money borrowed from depositors and must therefore be liable to these depositors. The corporate governance framework should, therefore, ensure aligning the interests of the management with equity and debt holders. The corporate governance of banks is intricately tied to the corporate governance of firms with former enforcing discipline through proper due diligence of conduct of corporate and their financial, while proper governance at corporate level help in safeguarding bank's interests.

Thirdly, ownership and group structure of banks in Pakistan is highly varied. The banking sector comprises of foreign-controlled, family-owned and some state-owned banks, with each type of ownership structure posturing its irregular governance challenges. Moreover, some banks operate as part of industrial/commercial groups while a large number of them have disclosure to the non-bank financial sector through ownership and control. In such a scenario, transparency

and fairness in banks' lending and investment decisions, particularly those pertaining to group companies, becomes a key requirement.

Finally, banks need to implement good governance practices and customer service standards in order to build public confidence in credibility of their operations. Banks operate in a highly susceptible environment where bonfire or superficial impression of malpractices in a bank's dealings could elicit a run on its deposits.

1.1.3: The Role of State Bank (SBP) of Pakistan

SBP has been on the front position in promoting good corporate governance in the Pakistan. Mostly as the regulator and supervisor of banks and DFIs, SBP has a fundamental role in direction-finding corporate governance reforms in the banking sector. In this view, SBP has implemented a inclusive corporate governance command for banks, which is driven by a vigorous legal and regulatory framework, risk-based regulation and over-arching banking sector reforms, particularly, privatization, liberalization and consolidation of banks. The major push of legal and regulatory requirements is to strengthen the functioning of the Boards of directors of banks. In setting out the responsibilities of the Board, SBP requires directors to focus on policy making and general direction, oversight and supervision of the business of the bank. The directors are expected to meet frequently, set up Board committees for audit, risk management, recruitment and compensation, and attend training programs to help them to perform their role as a director. In a recent move, SBP has separated the positions of chairman and *CEO of banks and made it mandatory on banks to appoint on the Board at least 25% independent /non-executive directors and not more than two executive directors*. SBP has also strengthened the fit and proper criteria and approves appointment of directors and CEO of banks in line with the criteria. Banks have to also follow the fit and proper criteria in appointing key executives although such

appointments do not require SBP endorsement. Recognizing the centrality of proper risk management in corporate governance framework, SBP has issued course of action on internal controls, risk management, IT security and business stability planning. Comprehensive instructions are available in the policy framework for banks. Risk management framework is laid out in the regulatory requirements that check banks' disclosure to group companies and other related parties, restrict disclosure to single borrower, borrowing group or sector, as well as limit banks' investments in equity market.

As a further step to strengthen governance of banks, they are required to undergo *credit rating annually*. The rating must be announced publicly and disclosed in the financial statements of the bank. SBP also requires banks to appoint auditors from a panel of pre-approved auditors maintained by it. The objective is to ensure credibility of audited financial statements of banks.

There are no properly globally accepted principles of corporate governance that can be applied to structures of the board as they depend on business practices and the political, legal and economic environment. However, the Cadbury Committee (1992) thought that board structure as an important instrument, which improved performance. They addressed separation of the roles of Chief Executives Officer (CEO) and Chairman, board structures, non-executives directors' representation and board committees.

1.2: Research Questions

There are a lot of studies on the importance of corporate governance in the past literature that promote the investors protection [(see, Shlelifer and Vishny (1997), La Porta *et al*. (1999), and Lin *et al*. (2009)]. The past literature found the link between corporate governance and firm performance [Danies (2001), Morck and Yang (2001), Ajlouni (2007) and Bhagat and Boltan (2008)); dividend policy (Mitton (2004) and Zhang (2008)].

During the last few decades, literature focused on different aspects of corporate governance. For example, Beiner *et al*. (2006) examine the impact of corporate governance on Swiss firm performance and find the positive relationship between firm value and board size. However, there is no significant impact of large block holders and controlling shareholders of the firms. Tomar and Bino (2012) inspect the influence of corporate governance on Jordanian bank performance and find that the affiliated boards of directors with banks have greater performance and lesser risk. However, there is no impact of number of directors on banks performance.

On the other hand, numerous studies have deliberated the firm financial decisions and factors that affecting such decisions (for example, Higgins (1981), Rozeff (1982), Lloyd *et al*. (1985), Pruitt and Gitman (1991) and Jensen *et al*. (1992)). The empirical evidences find the association between dividend policy and firm- specific factors, such as firm size (Fama and French, 2001), sales growth (Kania and Bacon (2005) Gill and Tibrewala (2010). The profitability and dividend policy relationship (Mitton (2005),Kania and Bacon (2005), Gill and Tibrewala (2010). The leverage and dividend relationship (Kania and Bacon (2005) and Gill and Tibrewala (2010). The investment opportunities and dividend policy relationship (Mitton (2004), Kania and Bacon 2005).

However, there are few studies that explained the relationship of corporate governance and dividend policy. Mitton (2004) find the relationship between and corporate governance and dividend payout ratio and concludes that firms with stronger corporate governance have higher dividend payout ratio, which is related with agency models of dividends. Zhang (2008) uses additional precise corporate governance variables and concludes the same results which are related with agency models of dividends. Firms in which the managerial membership on the board is high generally pay low dividend payment. Hamil and Al-Shattrat (2012) studies the

determinants of dividend payout ratio in Jordan and find that the level of institutional ownership, the number of shareholders and the level of insider ownership significantly affect the dividend payout ratio.

Therefore various research questions arise which includes

- Is there any relationship between corporate governance and dividend policy of banks listed on KSE?
- Do corporate governance practices for banks listed on KSE affect their dividend policy?

1.3: Research Objectives.

The objective of this study is to explain the impact of corporate governance on dividend policy of Pakistani banks listed in KSE. However, a good corporate governance practice on corporation working in the volatile environment of Pakistan has not been empirically and theoretically investigated. Therefore, the corporate governance practices that increases the value of listed banks in Pakistan, the study aim to: "*Explore the value of good corporate governance practices,* which affect the bank performance and dividend policy ensuring in responsibility to shareholder and stakeholders through business reporting practices, which increases the worth of listed banks in Pakistan."

The study examines the behavior corporate governance *practices of Islamic, privatized, and government owned banks* dividend policy. This study examines the association between corporate governance practices of board structures, ownership concentration on dividend policy of listed banks in Pakistan.

1.4: Significance of Study

Financial Institutions are very important for every economy because there are the most contributing factor to keep economies on the path of economic growth and development. For economic success of a country, market position of all sector in such country have great concern. The purpose of the study is to provide full picture of relationship between ownership structure and dividend policy to investors, management and shareholders.

This study contribute the corporate governance practices and banks dividend policy by investigating the corporate governance structures of Pakistan, and how these structures contribute firm performance and dividend policy. However, the relationships between dividend policy and corporate governance of banks in Pakistan have not been examined in existing study literature. In addition, in the unstable situation of Pakistan this type of study has not been studied in the previous literature.

Chapter 2: Theoretical Framework -Dividend Theories

In order to explain the dividend puzzle, the financial economists have explained three main theories of dividend policy. One theory that is given by Miller and Modigliani postulate that dividend payment is irrelevant and has no effect on firm 'stock price. Another theory the bird-in the-hand hypothesis set claims that dividend payment has a positive impact on firm's stock price. And the third theory tax effect hypothesis postulates that dividend payment has negative effect on firm's stock price. There are many other theories of dividend policy including the clientele hypothesis, the signaling hypothesis, the free cash flow hypothesis and the agency cost hypothesis.

2.1: Dividend Irrelevance Hypothesis:

Miller and Modigliani present the dividend irrelevance theory and provide a forceful and broadly accepted argument for dividend irrelevance in a perfect market. They suggest that in the world without any market imperfections like transaction cost, taxes or asymmetric information the dividend policy of a company is irrelevant. Their argument is that valuation of the company does not depend upon dividend payout policy but the valuation of the company only depends upon the productivity of the firm's asset. They demonstrate that the company's market value is determined by its investment policy and this policy as long as doesn't change, changing the mix of payout and retained earnings will not influence a firm's stock price. The irrelevance argument implies that the dividend policy has no valuable effect on stockholders wealth whether managers take much care in selecting dividend policy of their firms. In short dividends are irrelevant.

2.2: Bird-In-The-Hand Hypothesis:

Another view but dated view that dividend policy has increased the stock price. This is because dividend payment is a *"sure thing"* while there is doubt about future stock price appreciation. In other words, for the reason that stock prices are highly unpredictable, dividend is a more dependable form of return than capital gains. According to the *bird-in-the-hand hypothesis*, dividend payment has positive relationship with the stock prices. This is for the reason that higher dividend payout ratio will decrease the cost of capital (required rate of return), thus add to firm value. In this vein, Graham and Dodd (1951) argue that one dollar of dividends increases four times the stock price as one dollar of retained earnings.

However, *Miller and Modigliani* present the opposite idea that these is no relationship between dividend policy and the firm's required rate of return, for the reason is that investors are inconsistent between capital gains and dividends. In addition, they state that the risk of firm is from its operating cash flows not by distribution of its income. As a consequence, miller and Modigliani called the theory *"bird in the hand fallacy"* that dividend payout ratio will increase the market value of the firms. Similarly, Bhattacharya (1979) argues that the logic at the backside the bird-in-the-hand theory is fallacious. He claims that firm's risk is determined by the riskiness of a firm's cash flow. As a result, by decreasing the riskiness of future cash flows, the increase in dividend payment will not maximize the value of firm.

2.3: Agency Costs and Free Cash Flows Hypothesis:

A major portion of the literature is on agency problem between managers and shareholders. Managers always may not act in the favor of the firm owners due to the separation between ownership and control. Due to this agency costs incur to check the managers' behavior with shareholders. Dividend payments may help to reduce this agency costs between managers

and shareholders Jensen and Meckling (1976), Rozeff (1982), Esterbrook (1984), Jensen (1986), Crutchley and Hansen (1989), Jensen *et al*. (1992), Saxena (1999), and Keasey, Mollah, and Short (2000). In addition, when the firms pay large dividend payments, in this way discretionary internal cash flows are reduced and the firms take external finance from capital markets (Easterbrook 1984). In other words, to reduce the extra consumption of the firm, the capital markets provide an efficient controlling mechanism and hence decrease the agency problem.

Likewise, Jensen (1986) suggests about *free cash flow hypothesis* that when the free cash flows are available the managers invest these free cash flows in the projects of negative net present value (NPV). According to this hypothesis, managers engage in activities to maximize the size of the firm. By reducing the free cash flow, the dividend payments may help to control the overinvestment problem. Therefore, agency costs are reduced between managers and shareholders through dividend payments.

The conflict between bondholders and shareholders also the cause of agency costs. This type of conflict arises when the shareholders can seize wealth from bondholders by paying themselves dividends. Stated differently, dividend payment becomes the cause of reduction of funds available that are distributed to the bondholders (Jensen and Meckling (1976). Therefore, bondholders may be in favor to put some restrictions on dividend payments to make confident that the firm has a sufficient amount of money to pay them (Smith and Warner (1979). In contrast, shareholders are in favor of large dividend payments.

2.4: Signaling Hypothesis

Miller and Rock (1985), Williams and John (1985), and Bhattacharya (1979) develop the signaling, or asymmetric information models for paying dividend. They recommend that insider's managers select dividend payments level and increases dividend to signal the confidential information to investors. When the managers believe that the current market value of their company's stock less than its intrinsic value, managers take an incentives to signal this confidential information to the investors.

There are many studies in the support of the signaling hypothesis available. Swary and Aharony (1980), Mullins and Asquith (1986), argued that the dividend payment have a signaling effect. The top management of the company has more information about the plan of the company. And the top management can also forecast the future earnings of the firms. Therefore, employees have more information than the investors and the general market. So in this way, the problem of asymmetric information occurs. Hence, managers can send information to investors or to its shareholders in the market by using dividends as a signaling mechanism. And the other studies of Modiglini and Miller (1961), Healey and Palepu (1988) and Ziv and Nissim (2001) also argue that dividend payments may have a signaling effect.

The information may reveal the policies or the strategies of the firms that the firm is considering in the short run or long run. Managers can change the expectation of the investors about future earnings through dividends. Manager' of the firms has many ways to send the private information to the general market. Firms use the costly channels to send the information which will avoid smaller firms from imitating the signal. In this way, the price of dividend

increases; that is increasing dividend information. However, the firm must also be capable to maintain the costs of transferring the information.

On the other hand, although managers of the firms use dividend to convey private information, dividend changes announcement may not be a good signal. According to Easterbrook (1984), dividend changes may be a vague signal unless the market can differentiate between growing firms and disinvesting firms.

2.5: Clientele Effect

Miller and Modigliani (1963) describe the clientele effect by stating that each firm has its own different groups, or clienteles, of stockholder that prefer dividend payments. For example, pension funds, retired individuals and university endowment funds generally prefer cash income. Different investors have different needs and investment objectives. Investors have different goals such as: income generation, high growth, capital preservation, and other types of strategies. These goals differ in terms of investor's age, education expenses, family size, career, employment package and other characteristics.

Based on this statement, all investors perceive and classify stocks according to their financial and operating characteristics. This observation creates a clientele base for each kind of stocks. Hence, changing the characteristics of companies (e.g. product line, dividend and investment policy etc) can have an impact on the clientele. If the investors want to exit the company, they sell their stocks and buy another stock that meets their goals. Litzenberger and Ramasawmy (1979), Brigham and Houston (2004) state that when the firm change from one dividend payout policy to another so the stockholders can switch from one firm to another firm on their specific dividend preference**.** The top management of the firms should be hesitant at the

time of changing the dividend policy because the stockholders may sell their stocks and in this way the price may cut down.

2.6: Theoretical Review on Corporate Governance and Dividend Payout Policy

Before MM theory, many researchers believed that with no market imperfections, more the firm pays dividend, more its value increases. According to MM model (1958) under the perfect market assumption the capital structure is irrelevant for the financing decision of the firm, therefore, internal and external financing are perfect substitutes and dividend are irrelevant on the value of the firm.

Signaling theory, presented by Leland and Pyle (1977) says that the managers have greater access to the insider information of companies and they may share this information to the shareholders through an appropriate dividend policy e.g. constant or increasing dividend convey a positive signal about the firm or it may be the other way round. This theory is based on information asymmetry i.e. managers may indulge in insider trading and many not exhibit the true picture of company by the means of earning management. This theory suggests that if firm is running smoothly, this indicates that firm has sufficient resources. So, management can make dividend payments to signal that the firm is performing well and has the capacity to distribute its wealth. Similarly dividend non-payments can float a bad signal about the corporation's long run earnings and also about the quality of managers in the market Lintner (1956) because managers themselves believe that a consistent dividend payment by any firm reflects as a premium to the firm by market and dividend cuts are interpreted as negative signals Brave, *et al.* (2005). Any uninformed increase or decrease in dividends can cause an abnormal shock in stock price.

Free cash flow theory states that as the managers have access to firm's assets, after making all the payments and necessary investments if firm still has left some extra cash they can invest this extra cash in other projects. This extra investment also sends a positive signal regarding the firm's performance. But, sometimes mangers also may invest in negative NPV projects which send bad signals in the market. Free cash flow hypothesis expects a positive abnormal returns if the firm starts paying dividend instead of over investing. Rent extracting hypothesis postulates that majority shareholders exploit the payments of minority shareholders. They suggest that firm with lower investment opportunities should increase their dividends to reduce the free cash flow. Much of the research in corporate governance and dividend policy is derived through Agency theory, initially presented by Jensen and Meckling (1976). The agency problem arises when goal of principal and agent are not same i.e. when the control and ownership are separate and the information is not symmetric between both parties. This separation of control and information asymmetry causes agency problem which is mainly because the agents have inner or private information which they deliberately keep away from principals who are assumed to be risk averse Wienclaw (2009). The theory suggests that a principal hand over tasks to the agent and it is expected that agent will perform the task which would be value maximizing for the firm rather than one single party. When the agent tries to maximize his/her own interests then the agency problem comes up. Agency problem between principal and agent can also arise when the management decides to take-up new projects. In this case the conflict can be of this type: debt holders or managers try to take up only safe projects that can make sure that least payment is equal to the value of debt. Whereas, shareholders prefer risky projects because risky projects have returns higher than safe projects. Both parties try to shift the risk to the other parties. Therefore, Agency cost theory (1970) motivates the need of

strong corporate governance which deals with the main conflict (agency costs due to information asymmetry) between shareholders and the management and between shareholders and creditors. Corporate governance mechanisms help reducing such agency problems. The firms that implement better corporate governance practices are found to be relatively more profitable, more valuable and are able to pay more dividends to their shareholders Brown and Caylor (2004).

The fiduciary theory/model of corporate governance states that the principal gives the trusted person or trusted party the control of principal property or assets. The trusted person or fiduciary has least interest in the property or assets and uses his/her control to maximize the wealth of the principal party. The principal is the "shareholders" who are the true owner of the company and fiduciary is the management of the firm. But, it is observed that fiduciary are not solely interested in the benefit of shareholders but usually in their own [Grossman and Hart (1980); Easterbook (1984); Jenesen (1986)].

They all conclude that dividends play a role as a right to shareholders by not allowing all the 'free cash flow' to the managers. In other words, they suggest that is this way dividends play a role as 'regulation' for the right of shareholders. Because, in the presence of regulations, managers are less likely to cut the benefits of their own choice from the firm.

Chapter 3: Literature Review

3.1. Empirically Review of Corporate Governance and Dividend Policy:

Adjaoud and Amar (2007) investigate the relationship between corporate governance and dividend policy in Cananda. The study use the sample of 714 firms listed on Toronto Stock Exchange between the periods 2002 to 2005. The study reports the results that firms pay high dividend payments with strong corporate governance. They report results that board composition and shareholder rights policy have the positive association with the dividend payout ratios. They also document the results that there is positive relationship between firm size, the level of free cash flows and dividend payouts. In contrast, there is negative association between dividend payouts and firm risk.

Shubiri *et al*. (2010) examine an empirical investigation on relationship between ownership structure and dividend policy in Jordon. Using a sample of Jordanian industrial firms for the period of 2005-2009. The study shows the results that ownership structure approach is best way to an understanding the dividend policy in Jordan. The results show that institutional ownership and state ownership have the significantly negative association with the dividend per share and the level of dividend distributed to shareholders respectively. The results also show that higher the ownership of the five leading shareholders, the higher the dividend payments.

Ramli (2010) examine the ownership structure and dividend policy by taking the evidence from Malaysian companies. The main focus of their study is to examine the effect of the leading shareholder on the corporate dividend policy by taking the sample of Malaysian listed companies during the period 2002-2006. The study suggests the results that the leading

shareholders or a shareholder group owns around 40% of the company paid up capital. Tobit regression is used to analyze the results. The study suggests that the control of shareholder influence the dividend policy of Malaysian companies. So, higher the shareholders influence the higher dividend. The ownership of the shareholder affects a positive impact the dividend policy.

Fida *et al*. (2012) carried out a study "the impact of ownership structure on dividend policy evidence from emerging markets kse-100 index Pakistan". The study examines the determinants of the dividend policy in context of agency problems. Apply stepwise multiple regressions to examine the different ownership variables with the relation to the dividend policy. The study shows the negative association between the managerial ownership and the dividend policy that cause the agency problem. There is positive association between institutional and foreign share ownership with the dividend payouts. Thus, the ownership structure plays a key role to reduce the agency cost.

Pornsit *et al*. (2008) study the relationship between corporate governance and dividend policy on a sample of 16013 firm-years observations during the period 2001-2004. Research findings has shown that there is significant and positive relationship between corporate governance and payouts policy and this result also does not change after controlling for firm characteristics such as firm size, profitability and growth opportunities.

Ahmed and Javed (2008) investigate the study to determine the determinants of dividend policy of Pakistani non- financial firms listed in KSE between the periods 2001 to 2006. The lintner (1956) and its extending version is used to analyze the dividend policy. The study shows the results that non-financial firms of Pakistan rely on current dividend per share and current

earnings per share. The study shows the result that the ownership concentration and market liquidity effect positively with dividend policy. On the other hand, leverage and investment opportunity have the negative effect on the dividend policy. The size and market capitalization also have the effect on dividend policy

Nawaiseh *et al*. (2013) conduct a study on dividend policy and ownership structure. This study aims to determine the link of ownership structure and dividend policy of firms listed in Amman Stock Exchange. The study use a sample of 62 industrial firms listed in ASE between the periods of 2000 to 2006. The study uses the Tobit Model to test the hypothesis for the level of dividend. The study uses the leverage, profitability, firm size, family, stock, institution, insider, and foreigner as independent variables. The variable insiders have negative effect on dividend payout. The other ownership, family is negatively but not significantly effect on dividend policy. The institution ownership positively and significantly effects on dividend policy but the foreigner ownership positively and insignificantly influences the dividend policy.

Mitton (2004) in their study investigated the effect of corporate governance on dividend policy of 365 companies from 19 Asian countries. Using the agency model he showed that companies with higher rate of corporate governance will be higher interest payment. The research findings showed that in the companies with stronger corporate governance, there is negative and significant relationship between growth opportunities and dividend policy.

Rubin and Smith (2007) conduct a study on institutional ownership, volatility and dividends. The study aims to determine the effect of firm's dividend policy and institutional

ownership and stock return volatility. The study uses the a sample of 2000 leading firms listed in USA stock exchange market for the period 1998 to 2003. In this study, the dependent variables are dividend policy and volatility and ownership as independent variable. The descriptive statistic and multivariate regression are used to identify that dividend policy is affected by institutional ownership and volatility. There is negative relationship between institutional ownership and volatility among non-dividend paying stocks and positive correlation among dividend paying firms.

Afza and Mirza (2010) investigate a study on ownership structure and cash flows as determinants of corporate dividend policy in Pakistan. The study uses the data of 100 companies listed at KSE for the periods 2005 to 2007. In methodology, Ordinary Least Square (OLS) is used for analysis. Managerial ownership, individual ownership and other control variables are used as independent variable whereas dividend payout ratio and dividend intensity as dependent variables. The study shows the results that managerial and individual ownership, size, leverage and cash flow sensitivity are negative effect and profitability and operating cash flows are positively affect the cash dividend.

Kuwari (2009) carried out the study to determine the determinants of the dividend policy in Emerging Stock Exchanges. The Gulf Co-operation Council (GCC) countries are discussed in this study. Panel dataset in the study is used of non- financial firms that are listed on the GCC country Stock Exchange during the period between1999 to 2003. The random effect Tobit models are used in this study to investigate the seven hypotheses. The factors such as government ownership, firm size, free cash flows, growth rate, business risk, growth opportunity,

and firm profitability on dividend payout ratio. The study reports the results that firm size, firm profitability strongly and directly affect the dividend payments. The results also suggest that the dividend payments reduce the agency problems and built the firm reputation. The study also reports evidence that dividend policy depend upon the profitability of the firm.

Fakhari and Yosofalitabar (2010) in their study investigate the relationship between dividend policy and corporate governance. This study examines 125 companies among the listed companies in Tehran Stock Exchange during the years 2004-2007. Also indicators of corporate governance in this study were calculated based on a list which was divided to eight categories disclosure, business ethics, training of legal commitments observance, auditing, ownership, board structure, assets management and liquidity. The results suggest that there is negative and significant relationship between indicators of corporate governance and dividend.

Kowalewski *et al*. (2007) examine the relationship between corporate governance and dividend policy in Poland. The study uses the data between the periods 1998 to 2004. The aim of this is to investigate the combination of dividend policy and corporate governance. Return on assets is the used to calculate the dividend policy as dependent variable and corporate governance as independent variable. Regression model is used in this study. The study shows the results that the profitable firms pay high dividend and risky and less profitable firms pay less dividend to their shareholders.

Zulfiqar and Waseem (2012) conduct a study the impact of ownership structure on dividend policy of firms in Pakistan. The study uses the panel data of firms listed in KSE for the period of 2002 to 2006. The study uses the common effect model to analyze the relationship between ownership structures and dividend policy. The study shows the results that there is positive relationship between ownership structure and dividend policy.

Bokpin (2011) investigated the effect of ownership structure, corporate governance on dividend performance in Ghana companies. In this study, a sample of 23 companies was selected during the time span 2002-2007. The results showed that there is significant and positive relationship between board size and dividend and there is negative and significant relationship between financial leverage and dividend.

Knife (2011) investigates the study to find the factors affecting the dividend policy the case of banks in Ethiopia. The reason behind this study is to investigate the factors that influence the banks dividend policy in Ethiopia by using the data of 6 private banks during the period the 2006 to 2010. In this study he takes the dividend payout ratio as depended variable and the effect the last year's dividend, profitability, liquidity, leverage, sales growth, and firm size as independent variables. The study uses the Lintner's model and finds the results that past year dividend are used to fix the dividend payments the banks of Ethiopia. The study also reports that there is positive association between firm size and dividend payout ratio and no association between profitability, growth, and leverage and dividend payout ratio. Furthermore, the study finds that there is negative association between dividend payout and liquidity. At the time of decision to pay the dividends, the Ethiopia banks take into account agency conflicts, liquidity and past year's dividend, more than profitability, leverage and growth.

Yiadom and Agyei (2011) carried out a study on the determinants of the dividend policy of banks in Ghana. Fixed and random effects techniques are used on the panel data for the period of 1999-2003. The study used the sixteen banks .The study reports the results that collateral capacity, debt. Profitability and change in dividend have the significant and positive effect on dividend policy. On the other hand, age and growth have significant and negative effect on dividend policy of banks in Ghana. Cash flows have not significant but negative effect on dividend policy. The study also supports for the agency cost and profitability theory and partial support for life cycle theory and provide no support for free cash flows theory.

Sajid *et al*. (2012) investigate the impact of factors that affecting the dividend policy by taking a sample of eighteen banks listed in Karachi Stock Exchange during the period 2006-2011. In this study, dividend policy is dependent variable and firm size and risk, profitability, leverage and firm's growth are the independent variables. The study shows the results that firm size, growth and profitability have the positive correlation with dividend yield and dividend payout ratio. Profitability and firm size have strong but growth rate has weak positive correlation with dividend policy. In contrast, the firm risk and leverage has converse linear association with the dividend policy.

Kashif *et al*. (2013) carried out a study to investigate the factors that influence the dividend payout decisions among Pakistani banks. Employing the data of sixteen banks listed in KSE for empirical analysis. The study shows the results that earning per share, last year's dividend payouts, bank size and capital ratios are the critical factors that affect the dividend policy of banks. In contrast, cash flow has negative relationship with the dividend policy.

Halim and Bino (2010) carried out a study on corporate governance and dividend policy of Jordanian non- financial corporations. The aims of this study are to investigate the relationship of corporate governance and dividend policy, measured by firm's ownership structure. This study uses a sample of 110 non-financial corporations's listed on Amman Stock Exchange over the period 2004-2008. By using different econometric techniques, the study shows the results that there is a negative association dividend payout ratio and its capitals owned by blockholders. The study also shows the results that there is negative association between dividend payments and sales growth.

Subramanian *et al*. (2010) carried out a study on corporate governance and dividend policy in Malaysia. This study shows the support that the high growth firms pay less dividend payments. The study also shows the results that there is negative association between high growth firms, board size and investment opportunity. And there is weaker relationship between dividend payout and firms with a larger board size.

Demeh and Moh'd (2011) investigate the effect of corporate governance bank's dividend policy in Jordan. The study aims to examine the corporate governance measures and bank's dividend policy, and tax charges, growth rate, bank's book value and profitability as control variables. The study uses the data of all banks listed in Amman Stock Exchange for the period between of 2001-2009. In this study institutional ownership and top shareholders as a proxy for corporate governance. The study uses dividend payout ratio as a proxy for the dividends. The study reports the results that an institutional ownership or top shareholders pay higher dividend

payout ratio which supports the agency model of dividend. In addition, there is negative association between taxes, market valuation and profitability and dividend payout ratio.

Borokhovich *et al*. (2005) studied the relationship between board independence and dividend policy on a sample of 192 U.S. companies over the period 1992-1999. Research findings have shown that there is significant and negative relationship between board independence and dividend policy.

Kowaleski (2007) conducts a study to determine corporate governance and dividend policy in Poland. The study first examines the determinants of dividend policy in Poland. And then examine the corporate governance and dividend policy in non-financial firms listed on Warsaw Stock Exchange. The results show that the larger profitable firms pay higher dividend payout ratio. Moreover, riskier firms pay low dividend payout ratio. The study uses the TDI or its sub indices as a proxy for corporate governance. The results show that there is statistically significant positive relationship between corporate governance and dividend policy. And the study shows that the corporate governance is the significant determinants of the dividend policy.

Chen *et al*. (2011) tested the relationship between the financial characteristics, corporate governance and the tendency to pay cash dividends of Chinese Listed Companies. Their statistical sample consists of 1056 firm-year observations in the period 2001-2007. The results show that there is significant and positive relationship between the board size and composition of senior management with the tendency of companies to pay cash dividends. However, another

feature of corporate governance that is duality of CEOs' duty has significant and negative relationship with the tendency of companies to pay cash dividends.

Gill and Obradovich (2012) in their research studied the effect of corporate governance, institutional ownership on the decision to pay the amount of dividends. Statistical sample of this research has been formed from 296 U.S. companies listed in the New York Stock Exchange during the years 2009-2011. The research findings showed that there is positive and significant relationship between board size and duality of CEOs' duty with dividend policy. And there is significant and negative relationship between institutional investors and dividend policy.

Afzal and Saba (2011) investigate a study on ownership structure, board composition and dividend policy in Pakistan. The aims of this study is to determine the association of corporate governance and dividend policy of 42 non-financial firms listed on Karachi Stock Exchange from the period 2005- 2009. The study applies the OLS regression, Logit and Probit models for the estimation purpose. The study shows the results that there is positive and significant relationship between board size, individual ownership, firm size and investment opportunity with the dividend policy. The Logit and Probit models show the results that insider ownership and individual ownership negatively, while profitability positively and significantly affect the dividend decision. Investment opportunity positively but insignificantly affects the dividend decisions.

The above reviewed studies help in finding the gaps in the existing literature on dividend policy particularly in Pakistan. Due to unavailability of empirically determined affect of board of

director's characteristics on Pakistan's payout policy, this study is first of this kind that tests the impact of both, board of director's composition and ownership structure, on dividend policy of banks of the emerging capital market of Pakistan.

3.2: Hypothesis Development

Corporate governance is used as a powerful tool to control the agency cost. Corporate governance affects the dividend payout policy of the firms. Corporate governance is a collection of laws, policies and processes which control an organization. The ultimate aim of the corporate governance is to improve the firm's performance and eliminate the agency cost. Corporate governance involved the regulatory bodies of board of directors, shareholders, auditors and management. In this study the corporate governance measures are used board size, CEO duality, board independence/non-executive directors and block holders.

Board size and dividend policy

There is a limited amount of research discussing the relationship between dividend payout and the number of the board of directors in emerging markets and in particular in the Pakistan context. Prominent research has documented this effect (Belden *et al*. (2005) and Borokhovich *et al*. (2005) in developed markets. Nevertheless, the outcomes of these studies tend to be mixed.

Chang and Dutta's (2012) findings support the view that a smaller the number on the board will favor low dividend payment and vice versa. Therefore, small board size will lead to better corporate governance practices (Hu and Kumar, 2004). Klein (2002) argues that a large board size plays an effective role in monitoring of management; subsequently fewer dividends is required for monitoring purpose In addition Wu (2000) and Jensen (1993) argue that large board

size will lead miscommunication and miscorrelation between members. Hence large board size will create weak governance.

Thus, due to the mixed empirical results discussed above regarding the relationship between board size and dividend payout, this study re-examine this relationship for Pakistani banks over a longer period of time. Consequently, this study will identify whether a positive or negative relationship exists between board size and dividend payout. Hence, our hypothesis is:

Hypothesis No 1: There is a significant impact of board size on per share.

Board independence and dividend policy

According to Yermack (1996) board of directors with a higher percentage of external representatives is more likely to make higher dividend payouts to shareholders, as those directors are more likely to look after shareholders' interests. This is backed up by the research from Belden *et al*. (2005), who found that companies with a higher portion of external directors on the board will have a higher level of dividend payouts. Schellenger *et al*. (1989) suggested that outside directors may be in a better position to protect shareholders' interests than inside directors. The higher dividend payout will reduce agency costs as shareholders' funds are paid back to them. Adjaoud and Ben-Amar (2007) that board composition and shareholder rights policy have the positive association with the dividend payout ratios. However, a contradictory view is articulated in research carried out by Bathala and Rao (1995), that a board of directors with a high proportion of external directors is likely to have lower dividend payouts.

In an emerging market study, Abdulsalam *et al*. (2008) found no significant association between board independence and the dividend payout ratio. While corporate governance in Pakistan is considered sub-par (as in many other developing nations), Pakistan has introduced

laws over the past 10 years to protect shareholders' rights. According to Ghabayen (2012), the composition of the board of directors has a negative effect on firm performance (Return on Assets). Based on that we argue that these directors are nominated by banks then they might act as good monitoring device and will regularly affect dividend policy:

Hypothesis No 2: There is a significant relationship between board independence/non-executive directors and per share.

CEO duality and dividend policy

CEO composition has a big influence on the firm performance and ownership that's why they need to be properly monitored. For this purpose board is used because the board of the directors can monitor the activities of the CEO (Boyd, 1994). The main responsibility of management and performance lie with the directors and CEO (Core et at., 1999). According to Davis *et al*., (1997) duality in CEO is good for the company e.g. ownership theory suggested by arguing that the unity of command to take decisions is favorable for firms because the dual CEO goes for more debt financing to give a positive signal about the firm. In emerging market, most of the companies are family owned so CEOs hold dual position and work more in favor of the company (Anjum *et al*.,(2011) because in family owned firms CEOs can make sure the dividend payments to the shareholders. Mansorina *et al*., (2013) find that CEO duality has no effect on dividend policy. Gill & Obradovich (2011) find a negative relationship between CEO duality and dividend policy of the firms. Fama and Jensen, (1983) argue that the decision control and decision management, if separated, are best in interest of the corporation because this type of duality leads to agency problems. Nazir *et al*., (2012) find an insignificant but a positive relation of CEO duality and dividend payments.

Baliga *et al*. (1996) found that firms where chief executive officer is not the chairman of the board of directors, corporate governance mechanism is more effective there. Therefore, CEO duality (where CEO is also the chairman) is negatively related with effective corporate governance system. When corporate governance mechanism is weak, agency cost will be higher (Dittmar *et al*., 2003). D‟Souza and Saxena (1999) argue that agency cost is positively related with dividend payment of the firms. Batool and Javed (2013) find the positive and significant relationship between the CEO duality and dividend policy of the Pakistani firms. Therefore, mixed relation is expected between CEO duality and dividend payments of the banks.

Hypothesis No 3: There is significant relationship between CEO duality and dividend per share.

Bank size and dividend.

Seifert and Eddy (1988), Jensen *et al*. (1992), Redding (1997), and Fama and French (2001) report that large firms allocate a higher amount of their net income as cash dividends to their shareholders, than do small firms. Numerous studies have indicated the impact of firm size on the dividend-agency relationship. Jensen and Meckling (1976) argue that dividend policy may help to reduce agency costs in large size firms. When large amount of free or excess cash flows available to large firms then managers may invest these cash flows in negative NPV for their personal interests and these personal benefits may be mergers and acquisition to gain esteem from growth of firm or luxury consumptions and excessive salaries. Agency costs occur between managers and shareholders because managers can use free cash flows for their personal benefits. Llyed,*et al*. (1985) modify Rozeff's model by adding "firm size" as an additional variables. According to their consideration, it is an important variable; as large firms are increase their dividend payments to their shareholders to decrease agency costs. Dividend may be use as tool to

deal with this problem of agency conflicts in large firms because of monitoring hypothesis. Additionally, Sawicki (2005) illustrated that dividend payments can help to ultimately check the performance of managers in large companies. In large firms, ownership dispersion creates information asymmetry, decreasing the shareholders 'ability to examine the internal and external actions of the companies. Asymmetry information creates inefficient control by the management. Paying large dividends may be able a solution for such a problems. Easterbrook (1984) explains that when firms pay large excess cash flows as dividends payments to shareholders then firm have to take external finance and need for external finance leads to an increase in monitoring of large firms by creditors. This monitoring mechanism reduces the probability of non profitable investments by managers in large firms. Jensen (1986) argues that shareholders can minimize these cash flows problems by forcing managers to pay higher dividends in large firms. Hence, agency theory explains about positive relationship between firm size and dividend payout. Chang and Rhee (1990) argue that larger firm has easier access to capital markets at lower cost when financing need arises, so larger firms can afford to pay higher dividends as compare to smaller firms. Gayer et at. (1993), Holders *et al*. (1998) , Fama *et al*. (2001), Jones *et al*. (2001), and Aivazian *et al*. (2003) find empirically positive relationship between size and dividend payout of the firm.

There are many empirical research studies find the positive relationship between firm size and dividend payouts of the firms. Such studies Lloyd *et al*. (1985), DeAngelo , DeAngelo and Slutz (2006), Fama and French (2001), Dicken *et al*.(2002) and Holder *et al*, (1998) find the positive association between firm size and dividend payouts of the firms. Other studies Adjaoud and Kuwari (2009) finds positive association between size and dividend payouts of the firms in GCC emerging stock exchanges. There is a direct relationship between firm size and dividend

payout ratio of the firms in emerging market of china (Huang *et al*. 2011). Knife (2011) finds the positive relationship between dividend payout policy and firm size of the Ethiopia banking industry. Imran (2011) find the positive association between firm size and dividend per share in the case of engineering sector of Pakistan. The findings of this study are different in different countries of the world due to difference between country level and institutional factors such as GDP growth rate, inflation, corporate governance structure of the firms, banking system, legal system and development of markets.

On the basis of bank size, the following hypothesis is proposed:

Hypothesis No 4: There is significant positive relationship between bank size and dividend per share.

Profitability and dividend

The size of the firm's profit is a determinant of the dividend policy. When the firm has sufficient profit then the directors of the firm announce the dividend payments to their shareholders. Business performance is measured by the profitability. Profitability is a more important determinant of the dividend policy. The signaling theory explains that there is positive association between dividend policy and profitability of the firms. According to the pecking order theory, firm finance investment opportunities, retained earnings, debt financing and from external finance in a specific order (Myers and Majluf, 1984). (Easterbrook, 1984; Jensen, 1986) argue that more profitable firms will have greater likelihood to pay dividend in order to reduce agency costs of free cash flows in firms. Hence, agency cost theory explains about positive relationship between profitability and dividend payout of the firms. According to residual cash flows theory, firms pay more dividends when residual cash flows are high and vice versa. Hence

residual cash flows theory explains positive association profitability and dividends of the firms. Amidu and Abor (2006) and Naceur *et al*., (2006) empirically confirms positive relationship between profitability and dividend payouts of the firms.

In numerous various studies report positive association between profitability and dividend payouts of the firms (Fama and French, 2001; Gill *et al*, 2006; D angelo, D angelo and Slutz , 2006; Denis and Osobov ,2008; Renneboog and Trojanwski , 2010; Shabibi & Ramesh , 2011). In empirical studies of emerging economies such as India (Kumar, 2003; Anil & Kapoor, 2008), Pakistan (Ahmed and Javed, 2009), China (Huang *et al*, 2011) find positive relationship between profitability and dividend payouts of the firms in emerging economy of India. Al-Kuwari (2009) empirically finds positive relationship between profitability and dividend payouts of the firms in countries. Aivazian and Booth, (2003) find positive relationship between profitability and dividends of the firms in eight emerging economies.

On the basis of above discussions, the following hypothesis is proposed:

Hypothesis No 5: There is significant positive association between profitability and dividend policy.

Growth opportunities and dividend

Chen and Dhiensiri (2009) document that the firms pay low dividends that experience recent growth in revenues. The rapidly growing firms require high demand of capital. High growth firms are expected to follow low dividend payouts policy as compare to low growth firms because firms retains their profits to finance expansion and investments and to avoid the high cost of external finance (Rozeff , 1982). In this way the agency conflict decreases between managers and shareholders. Lower growth firms have lower investments expenditures and in this way they maintain higher retained earnings. Managers may use these retained earnings or cash

flows to invest in unprofitable projects if firm contain low growth opportunities, so best option in this situation is to distribute dividends among shareholders to reduce agency costs instead of wasting these funds in unprofitable projects (Jensen, 1986). According to the agency theory, there is negative association between growth and dividend policy of the firms. Lang *et al*. 1989 and Denis *et al*. (1994) confirm the negative association between growth and dividend payouts of the firms.

The pecking order theory states that firms must finance new projects first with retained earnings due to its least information-sensitive sources. Therefore, firms with high growth opportunities require greater portion of retained earnings to finance their investments as against returning these dividends to shareholders. Hence, pecking order theory also explains negative association between growth and dividend payouts of the firms. Barclay, Smith and Watts (1995), Gaver and Gaver (1993) and Glen *et al*, (1995) empirically find negative relationship between growth and dividend payouts of the firms.

In contrast, there are many studies that give the opposite relationship between growth opportunity and dividend policy. Fariba (2013) find in his study of “An empirical investigation on the effects of asymmetric information and growth opportunities on dividend polices: A case study of private Iranian banks” that there is positive relationship between growth opportunity and dividend policy on banks. Musiega *et al* (2013) find that the positive relationship between dividend policy on growth opportunity. Daradkah (2013) in the study of “The effect of corporate governance on bank's dividend policy: evidence from Jordan” find the positive relationship between growth opportunity and dividend payout ratio.

On the basis of growth opportunity, the following hypothesis is proposed:

Hypothesis No 6: There is negative relationship between growth opportunity and bank dividend per share.

Free Cash flows and dividend

Jensen (1986) argues that an agency conflict arises between managers and shareholders of firms when large free cash flows available. Managers may use free cash flows for investing in unprofitable projects or maximize their own wealth instead of using these funds to increase the value of shareholders. Dividend is the mechanism through which these agency problems can be tackling down, so firms with large free cash flows have to pay dividends in order to reduce agency conflicts managers and shareholders. Excessive cash flows reduces after paying large amount of dividends and firm borrows funds if firm faces shortage of finance for investments and in turn borrower increases their monitoring over firm and managers utilize funds in efficient manners in order to full the payment obligations of the borrowers . Hence, agency theory explains about the positive association between free cash flows and dividend payouts of the firms. Smith and Watts (1992), Jensen *et al*, (1992), La Porta (2000) and Mollah *et al*, (2002) confirms the theory of free cash flows hypothesis.

Holder *et al*, (1998) find that free cash flows are positively associated with dividend payouts of the firms. Adjaoud and Amar (2007) find that there is positive association between free cash flows and dividend payouts of the firms. In studies of emerging economies such as Ghana Amid and Abor, (2006) and India Anil & Kapoor, (2008) empirically find positive association between free cash flows and dividend payouts of the firms. In contrast, Imran (2011) find the negative association between the free cash flows and dividend per share in the case of Pakistani engineering sector. Imran *et al*. (2013) find the negative association between free cash flows and dividend payments in the case of Pakistani banking sector. Yiadom and Agyei (2011)

also find the negative relationship between free cash flows and dividend policy of banks in Ghana.

On the basis of free cash flows, the following hypothesis is proposed:

Hypothesis No 7: There is a significant impact of free cash flows on dividend per share.

Leverage and dividend

According to agency theory, Jensen (1986) argues that debt can use as alternate for dividends in reducing agency conflicts because when firms take high debt then debt repayments reduces the cash flows available to firm and chances of investment of free cash flows in unprofitable projects by managers also decreases and monitoring from capital mark*et al*so increases. This agency theory also explains negative association between debt and dividend payout of the firms. Kalay (1982) argues that debt covenants can force the firms to limit dividend payouts. Jensen *et al*. (1992) and Faccio *et al*. (2001) find empirically negative association between leverage and dividend payouts of the firms.

Gugler *et al*. (2003) and Al-Malkwai (2005) find negative relationship between leverage and dividend payout of the firms and argue that high leverage firms pay less dividends to shareholders, as high amount of interest plus principal payments reduce the firm's capacity to pay dividend to shareholders. Highly levered firms pay fewer dividends to maintain their liquidity position in order to fulfill the current and future debt obligation otherwise if firms unable to pay debt then risk of bankruptcy or liquidation arise.

The studies (Smith and Warner, 1979; Malitz, 1986, Leuz *et al*. 1998, Citron, 1992; Day and Taylor, 1996, Mather and Peirson, 2006, (Thoroton, 1992, Niskanen and Niskanen, 2004) suggest that debt covenants restrict dividend policy, so there is negative relationship between

leverage and dividend payouts of the firms. Al-Kuwari (2009) finds a negative association between leverage and dividends of the firms in the emerging stock exchanges of GCC countries. Kumar (2003) finds negative association between leverage and dividend payouts of the firms in emerging economy of India. On the basis of leverage, our hypothesis is that

Hypothesis No. 8: There is a significant negative relationship between leverage and dividend per share.

Chapter 4: Research Methodology

4.1: Data Description

This study analyses the impact of corporate governance on the dividend policy of the Pakistani banks. *Annual data of 22 banks including Islamic, privatized and state owned banks listed on KSE spanning from 2006 to 2012* are used for econometric analysis. The banks are selected in study, whose seven years financial balance sheet data and annual reports are available. Annual reports of each bank in each year are required for the construction of corporate governance variables. The data employed are derived from financial statement analysis of financial sector published by the State Bank of Pakistan and various annual reports of the banks that are listed on Karachi Stock Exchange (KSE). Annual reports from the chairman or chief executive officer for various banks were vital in relaying information about corporate governance issues.

4.2: Models:

The literature uses the different estimation techniques for the panel data models such as common constant method, fixed effect method, random effect method and pooled OLS dummy variable model. This study uses *the pooled dummy variable analysis* to check the impact of corporate governance on dividend policy of the banks. The reason of using the pooled OLS dummy variable analysis is that there are dummy variables are introduced in the model and this method is best to estimate the model. If we are using OLS regression model and dummy variables are introduced in the model than this technique is called the pooled OLS dummy variable analysis.

On the basis of selected variables the current study used the following econometric model

Equation No. 1:

$$Div_{it} = \alpha_0 + \propto_1 (board\ size)_{it} + \alpha_2(block\ holders)_{it} + \alpha_3(CEO\ deolity)_{it} + \propto_4 (non\ execute\ directors)_{it} + \propto_5 (bank\ size)_{it} + \alpha_6(free\ cash\ flows)_{it} + \alpha_7(profitability)_{it} + \alpha_8(growth\ opp)_{it} + \alpha_9(leverage)_{it} + \mu_{it}$$

Equation No. 2:

$$Div_{it} = \alpha_0 + \propto_1 (board\ size)_{it} + \alpha_2(block\ holders)_{it} + \alpha_3(CEO\ deolity)_{it} + \propto_4 (non\ execute\ directors)_{it} + \propto_5 (bank\ size)_{it} + \alpha_6(free\ cash\ flows)_{it} + \alpha_7(profitability)_{it} + \alpha_8(growth\ opp)_{it} + \propto_9 (leverage)_{it} + \propto_{10} (islamic\ dummy) + \mu_{it}$$

Equation No. 3:

$$Div_{it} = \alpha_0 + \propto_1 (board\ size)_{it} + \alpha_2 (block\ holders)_{it} + \alpha_3 (CEO\ deolity)_{it}$$
$$+ \propto_4 (non\ execute\ directors)_{it} + \propto_5 (bank\ size)_{it} + \alpha_6 (free\ cash\ flows)_{it}$$
$$+ \alpha_7 (profitability)_{it} + \alpha_8 (growth\ opp)_{it} + \propto_9 (leverage)_{it}$$
$$+ \propto_{10} (privatized\ dummy) + \mu_{it}$$

Equation No.4:

$$Div_{it} = \alpha_0 + \propto_1 (board\ size)_{it} + \alpha_2 (block\ holders)_{it} + \alpha_3 (CEO\ deolity)_{it}$$
$$+ \propto_4 (non\ execute\ directors)_{it} + \propto_5 (bank\ size)_{it} + \alpha_6 (free\ cash\ flows)_{it}$$
$$+ \alpha_7 (profitability)_{it} + \alpha_8 (growth\ opp)_{it} + \propto_9 (leverage)_{it}$$
$$+ \propto_{10} (government\ dummy) + \mu_{it}$$

4.3: **Descriptions of Variables**

Dependent Variable

- Dividend Policy:

  Dividend policy is measured by dividend per share.

Independent Variables:

Corporate governance mechanism is measured as:

- Block holders:

  Number of block holders holding 10% or more shares.

- CEO duality:

Following, Masulis *et al* (2007), Larcker *et al* (2011),*CEO duality is measured as dummy variable that is equal to 1* if the CEO is also the charemain of the board of director and zero otherwise.

- Board size:

  Board size is calculated as

The total number of directors sitting on the board (Li 1994). Klein (2002) argues that a large board size plays an effective role in monitoring of management. Another view describes large size boards as less effective monitoring tool (see for example, Yarmack, 1996).

Controlling Variables:

- Growth opportunity:

  Following the growth is measured as:

Growth is measured as the relative increase in the book value of the total assets during the year. *Tobin's Q is measured* sum of market value of equity minus book value of equity plus total assets divided by total assets.

- Profitability or Performance

Measured by:

Return on assets (ROA, defined as the ratio of earnings before interest and taxes divided by total assets).

- Bank size:

Measured by:

Bank size is measured by the log of book value of total assets (Masulis, *et al* 2007 and Mueller and Xavier 2011, BØhren, *et al*, 2012).

- Free cash flows**:**

FCF is measured by in following equation.

Earnings before interest and taxes (EBIT) plus book value of depreciation allowances and amortization are used as a proxy of free cash flows.

- Dummy Variable

"Islamic dummy" if bank is Islamic is equal to"1" and non-Islamic bank for "0".

In Other Equation Dummy Variable

"Privatized dummy" if bank is privatized is equal to"1" and non-privatized bank for "0".

"Government dummy" if bank is Government is equal to"1" and non-Government bank for "0".

Chapter 5: Results of Regression Analysis

The empirical analysis of this study is divided into four parts. The analysis begins by testing the model to assess the impact of corporate governance on dividend policy of banks listed in KSE. The model is extended by bank specific factors that influence the dividend policy of the banks in Pakistan. In the third part the model is extended by adding the dummy variables of Islamic verses non Islamic bank's corporate governance on dividend policy. In the fourth part the model is extended by adding the dummy variables of privatized verses non privatized bank's corporate governance on dividend policy. In the fifth part the model is extended by adding the dummy variables of government owned verses non-government owned bank's corporate governance on dividend policy. Since the main focus of the study is to examine the impact of corporate governance on dividend policy of the banks in Pakistan. All the above models are tested on the bases of pooled dummy variable analysis model.

Correlation and Multicollinearity Analysis

The results in table below show that the presence of multicollinearity among the independent variables is minimal.

Table: 5.1*Correlation and multicollinearity matrix*

	DPS	BLOCK	BSIZE	DUALITY	NEX	FCASH	PRO	GRO	SIZE	LEVRG
DPS	1.000000									
BLOCK	-0.105268	1.000000								
BSIZE	- 0.031004	-0.187650	1.000000							
DUALITY	0.130115	-0.197583	-0.252980	1.000000						
NEX	0.170206	-0.049085	0.554030	-0.410683	1.000000					
FCASH	0.417134	-0.034269	0.156393	0.010892	0.138093	1.000000				
PRO	0.438117	-0.112401	0.158506	-0.014841	0.067359	0.453604	1.000000			
GRO	0.071301	-0.044574	0.288421	0.039446	0.164656	0.071671	-0.001062	1.000000		
SIZE	0.564150	-0.193300	0.085364	0.157369	0.053589	0.482420	0.523581	0.059917	1.000000	
LEVRG	-0.012569	0.170790	0.080331	0.024683	0.027191	0.152364	0.061630	0.112924	0.509356	1.000000

Note .DPS show dividend per share, block show block holders having 10% shares, BSIZE show board size, NEX shows non-executive directors, FCASH show free cash flows per share, PRO show profitability, GRO shows growth opportunity, SIZE shows size of the banks, LEVRG shows the leverage (debt).

Summary Statistics

Table below presents the descriptive statistics for the determinants of dividend payout of firms in the financial sector in Pakistan. From the table, mean, median, minimum and maximum values for each of the variables are displayed.

Table: 5.2 *Descriptive Summary Statistics (banks in the Financial Sector)*

VARIABLES	DPS	BSIZE	BLOCK	DUALITY	NEX	FCASH	PRO	GRO	SIZE	LEVRG
Mean	2.130519	8.474026	1.883117	0.090909	6.344156	26.88401	0.518560	1.030904	8.187009	0.887951
Median	0.000000	8.000000	2.000000	0.000000	6.000000	12.43500	1.219794	1.004658	8.258831	0.914347
Maximum	20.00000	13.00000	8.000000	1.000000	12.00000	333.5000	5.407841	1.684917	9.206909	0.984245
Minimum	0.000000	4.000000	0.000000	0.000000	0.000000	-91.50000	-10.37264	0.723899	6.604731	0.460574
Std. Dev.	3.513365	1.669402	1.303329	0.288418	1.921260	44.82171	2.934193	0.136086	0.528961	0.074262

Note .DPS show dividend per share, block show block holders having 10% shares, BSIZE show board size, NEX shows non-executive directors, FCASH shows free cash flows per share, PRO show profitability, GRO shows growth opportunity, SIZE shows size of the banks, LEVRG shows the leverage (debt).

__Table: 5.3__ Results of Model with Corporate Governance and Bank Specific Variables

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-9.2059**	3.6078	-2.5517	0.0118
BSIZE	-0.2929*	0.1661	-1.7635	0.0799
NEX	0.4597***	0.1438	3.1972	0.0017
DUALITY	1.8823**	0.8605	2.1875	0.0303
BLOCK	0.0388	0.1783	0.2178	0.8279
FCASH	0.0147***	0.0056	2.6375	0.0093
SIZE2	2.5586***	0.4299	5.9513	0.0000
GRO	-3.0363*	1.8385	-1.6515	0.1008
PRO	0.1656*	0.0921	1.7977	0.0743
LEVRG	-5.4454*	3.0248	-1.8003	0.0739
*,**,*** shows significance at 10%,5% and 1% respectively				

This model includes the corporate governance and control variables in the model. The pooled OLS dummy variable analysis model is used. The result of Pooled dummy variable analysis model suggests that CEO duality also has positive relation with the dependent variable dividend per share. Because Pakistani firms are about 59 percent family owned Cheema, *et al.* (2003), therefore CEO is also the part of family and their dual role strengthen management and work in favor of majority shareholders. Baliga *et al*. (1996) and Tsui *et al*. (2001) argue that the board where the CEO is not the chairman the board is a more effective control mechanism than when CEO is also the chairman of the board. Here one person is the chairman as well as the CEO of the board who strongly monitors the board and to avoid the misuse of cash balances, he declares the dividend payment. Other supporting findings are from the studies of Davis, *et al*.

(1997), Anjum, *et al*. (2011), however, the findings of Gill and Borokhovich (2011) and Fama and Jensen (1983) do not support our findings.

Board independence/non-executive (NEX) directors show a positive and significant relation with dividend per share in above mentioned estimation techniques. This result suggests that since Pakistani banks are not family owned and there is very large number of independent nominees present in the board, so, they affect the board decisions. There are many studies that provide the evidence of our results. Schellenger *et al*. (1989, p. 457) found a positive correlation between the percentage of outside directorships on boards and dividend payout. They conclude that the findings provide evidence that the composition of the board of directors affects dividend policy. Schellenger *et al*. (1989) suggested that outside directors may be in a better position to protect shareholders' interests than inside directors. Kaplan and Reishus (1990) and Belden *et al*. (2005) provide the same results that are in favor of our results.

These results are opposite of the findings of [Mansorina, *et al*. (2013); Chen, *et al.* (2011); Gill and Obradovich (2005); Hermalin (2005); Bathala and Rao (1995); Rashid, Zoya, Lodh, and Rudkin (2010); Shah, *et al.* (2011)].

Board size (BSIZE) has a negative and significant relation with dividend policy indicating that as the board size increases than more than then the sufficient number of board of directors in board, it creates a negative impact on consensus of the management on dividend distribution decisions of firms. Negative result also suggests that as the board size increases, the dividend payments decrease because larger boards may create free rider problem. These findings are in line with those of [Setayesh and Embrahimi (2013); Hellman and Puri (2000)] but are

contradictory with the findings of [Manosorina, *et al*. (2013); Chen, *et al.* (2011) and Bopkin (2011); Afzal and Sehrish (2010)].

The second model of regression analysis relates to those bank specific factors that influence the dividend policy of Pakistani banks listed in KSE. For examination of banks specific factors the study uses following explanatory variables: Growth opportunity, Growth is measured as the relative increase in the book value of the total assets during the year, (BØhren *et al*, 2012). Tobin's Q is measured sum of market value of equity minus book value of equity plus total assets divided by total assets. Profitability or Performance is measured by return on assets (ROA, defined as the ratio of earnings before interest and taxes divided by total assets). The bank size is measured by the log of book value of total assets (Masulis, *et al* 2007 and Mueller and Xavier 2011, BØhren, *et al*, 2012). Free cash flows measured by earnings before interest and taxes (EBIT) plus book value of depreciation allowances and amortization use as a proxy of free cash flows. And Debt equity ratio *(DE)* as measure of banks leverages position.

This model incorporates banks specific determinants suggested by empirical literature in the model. The results of the pooled dummy variable analysis model shows that the size of bank captured by market capitalization shows the positive and significant relationship with the dividend yield by using the estimation techniques mentioned above suggesting that large sized banks pay more dividend. This evidence is confirmed by the findings of Belans, *et al.* (2007), Jeong (2008). There are many empirical studies supported the results loyd *et al*. (1985), DeAngelo DeAngelo and Slutz (2006), Fama and French (2001), Dicken *et al*.(2000), Adjaoud and Al-Kuwari (2009), and Holder *et al*, (1998) find the positive association between firm size and dividend payouts of the firms.

Profitability *(ROA)* shows a positive and significant relation with dividend per share in all models which means that acceptance of the hypothesis that profitability positively effects dividend policy of banks. The banks with high profitability are capable of paying more dividends because dividend payments rely more on cash flows than the earnings or profitability Alli, *et al*. (1993). Aivazian, Booth and Clearly (2003) show that profitability plays a significant role in determining dividend policy. As these banks earn more they are expected to distribute more in form of dividends. Amidu, *et al*. (2006) finds a positive relation of dividends with firms' profitability. (Fama and French, 2001; Gill *et al*, 2006; Deangelo, Deangelo and Slutz , 2006; Denis and Osobov ,2008; Renneboog and Trojanwski , 2010; Al Shabibi & Ramesh , 2011),(Kumar, 2003; Anil & Kapoor, 2008), Pakistan based (Ahmed and Javid, 2009), (Huang *et al*, 2011) find positive relationship between profitability and dividend payouts of the firms in emerging economy.

The growth opportunity shows the negative and significant relationship with dividend policy. *"The pecking order theory sates* that firms must finance new projects first with retained earnings due to its least information-sensitive sources". Therefore, firms with high growth opportunities require greater portion of retained earnings to finance their investments as against returning these dividends to shareholders. Hence, pecking order theory also explains negative association between growth and dividend payouts of the firms. Barclay, Smith and Watts (1995), Gaver and Gaver (1993) and Glen *et al*, (1995) empirically support the results of this study that there is negative relationship between growth opportunity and dividend payouts of the banks.

This study shows a negative and statistically significant relationship between leverage and dividend payout ratios. This negative association is in line with the agency theory and could be explained in a way that banks" with low debt ratio have a propensity to pay high dividends and increasing leverage is related with decrease in dividend payout. A number of previous studies reported statistically significant and negative relationship between financial leverage and dividend payout, Jensen *et al.,* (1992) and Aivazian *et al.* (2003, (Aivazian *et al.* 2003, p. 380). Kowalski *et al* (2007) argued that more indebted firms prefer to pay lower dividends. Also, Al-Kuwari (2009) confirmed that dividend policy is negatively related to leverage ratio.

This study shows that a positive and statistically significant relationship between dividend per share and cash flow per share. It can be interpreted that banks have more cash flow so they have several options to use it and of distributing among shareholders as dividend, and thus cash flow has a positive relationship with dividend payout. There are many studies that supports the results Holder *et al*, (1998),Smith and Watts (1992), Jensen *et al*, (1992), La Porta (2000) and Mollah *et al*, (2002), Adjaoud and Ben-Amar (2007), Amid and Abor, 2006), (Anil & Kapoor, 2008) confirm the theory of free cash flows hypothesis. On the other hand there many studies those are not in favor of the results, Yiadom and Agyei (2011), Kashif *et al*. (2013) finds the negative association between free cash flows and dividend payments. They said that free cash flows create the agency conflicts. When the free cash flows are available the managers invest free cash flows in the projects of negative present value (NPV). By reducing the free cash flows, dividend payments may help to control the overinvestment problems.

Results Discussions Islamic Verses Non Islamic Banks

The third part of regression analysis relates to the Islamic banks verses non-Islamic banks that to check the corporate governance of Islamic banks in Pakistan has the different behavior

from non-Islamic banks dividend or having the same behavior of Islamic banks corporate governance. For this in this part we use the dummy variables. For Islamic banks use "1" if the bank is Islamic otherwise "0" for conventional banks. Next we use the interaction term of corporate governance variables such as board size, CEO duality, non-executive directors, and block holders with the dummy variables. The variables become after multiplying the corporate governance variables and Islamic banks dummy are *BSIZE*ISDUMMY, DUALITY*ISDUMMY, NEX*ISDUMMY AND BLOCK*ISDUMMY*. In this way we check the behavior of corporate governance of Islamic banks on dividend policy of the Islamic banks listed in KSE.

Table: 5.4 *Results Discussions Islamic Verses Non Islamic Banks*

Variable	Coefficient	Std. Error	T. State	Prob.
C	-7.7571	3.5057	-2.2127	0.0285
BSIZE	-0.5099***	0.1739	-2.9314	0.0039
NEX	0.1659	0.1527	1.0860	0.2793
DUALITY	0.8542	1.0618	0.8045	0.4224
BLOCK	-0.1549	0.1834	-0.8445	0.3998
PRO	0.1796**	0.0849	2.1158	0.0361
SIZE2	2.3940***	0.4336	5.5218	0.0000
ISBSIZE	-2.8689***	0.7622	-3.7641	0.0002
ISNEX	3.9454***	0.8882	4.4418	0.0000
ISDUALITY	0.2130	1.3539	0.1574	0.8752
ISBLOCK	-1.0060**	0.4291	-2.3443	0.0205
LEVRG	-2.0803	2.9160	-0.7134	0.4768
*,**,*** shows significance at 10%,5% and 1% respectively				

The table 5.4 shows the all variables uses in the model. The table shows the results that the board size (BSIZE) has negative and significant relationship with the dependent variable of dividend per share. These are the same results as when we use the interaction term of Islamic banks and board size *(BSIZE).* The variable *(ISBIZE)* shows the negative and significant relationship with the dividend per share. It means that in Islamic banks board size has the impact of dividend per share but in negative direction. In Islamic banks of Pakistan board size has a negative and significant relation with dividend policy indicating that as the board size it creates a negative impact on consensus of the management on dividend distribution decisions of firms. Negative result also suggests that as the board size increases, the dividend payments decrease because larger boards may create free rider problem. Islamic banks pay fewer dividends as compared to non-Islamic banks in case Pakistan considering the board size of the Islamic banks.

The interaction term of board independence/ non-executive directors and the Islamic banks dummy variables *(ISNEX)* shows the positive and significant relationship with the dividend per share in the above table. It means that the Islamic banks in Pakistan are not family owned and there is greater number of independent nominees present in the board, so, they affect the board decisions. These results show that as the non-executive directors in Islamic banks tend to pay higher dividends as compared to their counterparts non-Islamic banks.

The interaction term of CEO duality and Islamic banks *(ISDUALITY)* shows positive but insignificant relationship with the dividend per share in the above table. So the chairman and the chief executive officer is the not the same person in the Islamic banks of Pakistan. So the positive relationship shows that CEO duality n Islamic banks can affect the dividend policy in positive way but not significantly.

The interaction term of block holders and Islamic banks dummy variable (ISBLOCK) shows the negative and significantly relationship with the dividend per share in the above table. It means that in Pakistan, in the Islamic banks the block holders have the negative impact on dividend policy. As the numbers of block holders in the Islamic banks are increases the dividend per share decreases.

Results Discussions of Privatized Verses Non-Privatized Banks.

The fourth part of regression analysis is related to the privatized verses non-privatized banks to check the corporate governance of privatized banks in Pakistan has the different behavior from non-privatized banks dividend policy or not. For this, we use the dummy variables privatized banks use “1” if the banks are privatized otherwise “0” for non-privatized banks. To check this, we use the interaction term of corporate governance variables such as board size, CEO duality, non-executive directors, and block holders with the privatized banks dummy variables. The variables become after multiplying the corporate governance variables and privatized banks dummy are *BSIZE*PDUMMY, DUALITY*PDUMMY, NEX*PDUMMY and BLOCK*PDUMMY*. In this way we check the difference of corporate governance of privatized banks on dividend policy of the banks listed in KSE.

Table: 5.5 *Results Discussions of Privatized Verses Non-Privatized Banks*

Variable	Coefficient	Std. Error	T-Statistic	Prob.
C	-2.9580	3.4844	-0.8489	0.3974
BLOCK	-0.1530	0.1878	-0.8144	0.4168
BSIZE	-0.4022**	0.1645	-2.4444	0.0157
NEX	0.2659	0.1756	1.5139	0.1323
PBLOCK	-1.3853**	0.6407	-2.1622	0.0323
PBSIZE	-1.005***	0.4490	-2.7997	0.0268
PNEX	-0.3276	0.4249	-0.7709	0.4421
DUALITY	1.9951**	0.8024	2.4866	0.0141
FCASH	0.0074	0.0053	1.4096	0.1609
SIZE2	1.7277***	0.4497	3.8421	0.0002
GRO	-3.6964**	1.6982	-2.1766	0.0312
PRO	0.0808	0.0842	0.9599	0.3388
LEVRG	-2.8358	2.7383	-1.0356	0.3022
*,**,*** shows significance at 10%,5% and 1% respectively				

The table 5.5 shows the results that the board size *(BSIZE)* has negative and significant relationship with the dependent variable of dividend per share. These are the same results as when we use the interaction term of privatized banks and board size *(BSIZE).* The variable *(PBIZE)* shows the negative and significant relationship with the dividend per share. It means that in privatized banks board size has the impact of dividend per share but in negative direction. In privatized banks in Pakistan board size has a negative and significant relation with dividend policy indicating that as the board size increases than more than the sufficient number of board of directors in board, it creates a negative impact on consensus of the management on dividend distribution decisions of banks. Negative result also suggests that as the board size increases, the

dividend payments decrease in the privatized banks because larger boards may create free rider problem.

The interaction term of board independence/ non-executive directors and the privatized banks dummy variables *(PNEX)* shows the negative but insignificant relationship with the dividend per share in the above table. It means that non-executive does not behave in different way if banks ownership is changed.

Results Discussions of Government Verses Non-Government Banks

The fifth part of regression analysis relates to the government banks verses non-government banks whether the corporate governance of government banks in Pakistan is different from non-government banks dividend policy or having the same behavior of government banks corporate governance. For this we use the dummy variable of government bank as "1" if the banks are government banks otherwise "0". To check this combined affect we use the interaction term of corporate governance variables such as board size, CEO duality, non-executive directors, and block holders with the government banks dummy variables. The variables become after multiplying the corporate governance variables and government banks dummy are *BSIZE*GDUMMY, DUALITYGPDUMMY, NEX*GDUMMY and BLOCK*GDUMMY*. In this way, we check the behavior of corporate governance of government banks on dividend policy of the banks listed in KSE.

Table: *5.6 Results Discussions of Government Verses Non-Government Banks*

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-9.3020**	3.7877	-2.4559	0.0153
BLOCK	-0.0527	0.1814	-0.2905	0.7718
BSIZE	-0.2837	0.1881	-1.5081	0.1338
NEX	0.4578***	0.1619	2.8284	0.0054
DUALITY	1.9270	1.2751	1.5112	0.1330
GBLOCK	1.2290	1.6434	0.7478	0.4558
GBSIZE	-0.2743	0.5687	-0.4822	0.6304
GNEX	-0.0064	0.7513	-0.0085	0.9932
FCASH	0.0141**	0.0057	2.4853	0.0141
SIZE2	2.5867***	0.4664	5.5457	0.0000
GRO	-3.1403*	1.8903	-1.6613	0.0989
*,**,*** shows significance at 10%,5% and 1% respectively				

The table 5.6 shows the results that the board size *(BSIZE)* has negative but insignificant relationship with the dependent variable of dividend per share. These are the same results as when we use the interaction term of government banks and board size *(GBSIZE*). The variable *GBSIZE* shows the negative and insignificant relationship with the dividend per share. It means that directors in government banks do not behave differently while determining the dividend policy of the bank.

The interaction term of board independence/ non-executive directors and the government banks dummy variables *(GNEX)* shows the negative insignificant relationship with the dividend per share. It means the having government ownership does not affect the governance variable and their decision of the banks dividends.

Chapter 6: Conclusions and Policy Implications

6.1: Conclusions

There is an enormous diversity of literature on dividend policy and many dividends theories have been presented by the researchers on the very topic such as agency theory, signaling theory, and free cash flow theories etc., but still, after decades of research "dividend puzzle" is unsolved. The current empirical literature discusses corporate governance and its impact on dividend policy which leads to the essential argument of the current study. The sample in this study consists of 22 banks listed on Karachi Stock Exchange.

This study tries to find that do the listed banks of Karachi Stock Exchange follow a dividend policy? How does the corporate governance affect dividend policy of banks? What are the banks specific factors that influence the dividend policy of Pakistani listed banks? And finally, how do the Islamic, Privatized and Government banks corporate governance effect the dividend policy of banks.

The results of study show that banks listed on Karachi stock exchange pay their dividends. However, as the dividend payouts are voluntary therefore only few banks pay dividend. The state bank of Pakistan has lately revised code of Corporate Governance and some steps are taken to ensure investor protection; therefore it is expected that as soon as the revised Code of Corporate Governance is implemented by the banking sector, their dividend payout would likely be increased.

The results of this study suggest that Pakistani banks only pay a small proportion of their earnings as dividends but since managers are reluctant to make dividend changes. In the second part banks specific variables are included in model along with corporate governance variables. The results indicate that among the specific factors dividend payout is positively associated with

profitability, size of the bank, growth opportunity and negatively associated with leverage. These results suggest that pro-growth policies will lead to the expansion of the banks, which means more profitability, large size and increased earnings increase and as a result banks chose to pay more dividends payments. Whereas, low debt polices also transform in higher dividend payments.

The study suggests that the Corporate Governance system have significant effect on the dividend policy in Pakistan, because it resolves agency costs. Results of the study indicate that CEO duality, Board independence, and are positively associated with dividend payments (dividend per share), and board size, ownership structure, negatively associated with dividend payments, which indicates that in Pakistan with poor investor protection only those banks tend to pay dividend which have a stronger independent board with strong external auditing system. So, a stronger Code of Corporate Governance is required which would direct companies towards shareholder protection and hence a higher dividend payment.

This can only be happen if the firm has strong corporate governance structure. In this case, banking sector in Pakistan was influenced by the government authorities with weak governance which results in a low performing sector, but after making the necessary changes in the governance structure the very sector evident a phenomenon growth and high returns in it. We believe there are still some gaps left in the governance structure of the banking sector in Pakistan, but these gaps will fill up by the Islamic Banks due to their more reliable governance structure. The results of this study suggest that there is an important role of corporate governance in the performance of banking sector of Pakistan either it is conventional or Islamic. There is a clear clue that the presence of Shari's board affects the return on equity and technical efficiency of banking sector. This is a preliminary level effort in this regard. The study can be extended by

adding more complex variables of corporate governance and observe their influences on the performance and dividend policy of banking sector in Pakistan.

6.2: Policy Implications

The results of this study show that the banks of Pakistani do not follow the smooth pattern of dividend policy. However, as the dividend payments are voluntary therefore only a few banks pay dividend. The SBP has revised the code of corporate governance and some steps to ensure investor protection are taken, therefore it is expected that as soon as the revised code of corporate governance is implemented by the banks, their dividend payout would be increased.

It is important to mention that the code of corporate governance 2002 issued by the state bank of Pakistan is not enough to manage the minority shareholder rights. Adequate measures should be taken to enhance efficiency and effectiveness of governance frameworks in the banking sector. Stakeholders should be adequately knowledgeable on the relevant laws, rights, responsibilities and ethical requirements.

The data has been gathered for 7 years only i.e. 2006-2012 and only listed banks that regularly pay and do not pay dividend have been included in the sample. Despite these limitations, the results of this study and above suggested policies will help the management of corporations and policy makers to design their future policies where dividend payment would be encouraged and the diverse range of shareholders would also be satisfied.

In further, researchers may extend this work by comparing financial and non-financial firms, public and private firms or by including the firms owned by state. The impact of the element of corporate governance, composition of audit committee, can also be tested on dividend policy.

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