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Dividend Policy and Its Effect on Shareholder Wealth in the Banking and Financial Services Sector

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ABSTRACT :

Dividend policy has long been a pivotal component of corporate financial strategy, especially in sectors with stringent regulatory oversight such as banking. In the context of the Indian banking and financial services sector, this study explores the influence of dividend policy variables—Dividend per Share (DPS), Dividend Payout Ratio (DPR), and Dividend Yield (DY)—on shareholder wealth indicators including share price, Earnings per Share (EPS), and Return on Equity (ROE). Drawing on data from 12 institutions over a decade (2014–2024), the research employs descriptive statistics, correlation, and multiple regression techniques to determine the nature and strength of these relationships. Results reveal a significant positive impact of DPS on share price, aligning with the signaling hypothesis and Bird-in-Hand theory. These findings underscore the role of stable and strategic dividend policies in enhancing shareholder value, particularly in privately-owned financial institutions. The study provides actionable insights for managers, investors, and regulators navigating the evolving financial landscape.

Key words:

Dividend Policy, Shareholder Wealth, Dividend per Share (DPS), Dividend Payout Ratio (DPR), Dividend Yield (DY), Earnings per Share (EPS), Return on Equity (ROE), Signaling Theory, Bird-in-Hand Theory, Indian Banking Sector, Public and Private Banks, Non-Banking Financial Companies (NBFCs), Stock Market Performance, Capital Adequacy, Regulatory Framework (RBI, Basel III), Financial Management, Event Study, Corporate Finance, Market Signaling, Empirical Analysis

Introduction

Dividend policy is a cornerstone of corporate financial management. It represents a firm's approach to distributing earnings back to shareholders, usually in the form of dividends. In capital-intensive and highly regulated sectors like banking, dividend decisions carry added significance. Indian banks, regulated by the Reserve Bank of India (RBI) under stringent capital adequacy norms (e.g., Basel III), often face the dilemma of rewarding shareholders while maintaining sufficient reserves to meet regulatory and operational requirements.

This study investigates how dividend policy impacts shareholder wealth in the Indian banking sector, which includes public sector banks, private sector banks, non-banking financial companies (NBFCs), and foreign banks operating in India. Shareholder wealth, often reflected in stock price appreciation and returns, is significantly influenced by perceptions of a company's financial health and strategic intent. A well-structured and consistent dividend policy can reinforce investor confidence, affect firm valuation, and ultimately guide investor behaviour.

The objective of this research is to empirically evaluate whether and how different aspects of dividend policy—specifically DPS, DPR, and DY—affect key shareholder wealth indicators. Understanding these relationships will enable financial managers and policymakers to craft more effective dividend strategies and regulatory frameworks.

Literature Review

Dividend policy remains one of the most debated issues in corporate finance, with various theoretical and empirical viewpoints.

Classical Theories

- **Dividend Irrelevance Theory (Miller and Modigliani, 1961):** Suggests that dividend policy has no impact on firm value in a perfect market.
- **Bird-in-Hand Theory (Gordon, 1959; Lintner, 1956):** Argues that investors prefer dividends over potential future capital gains because of reduced uncertainty.
- **Walter's Model (1956):** Highlights that the relationship between dividend policy and the firm's rate of return relative to its cost of capital determines the impact on shareholder wealth.

Signaling Theory

Developed by Bhattacharya (1979) and extended by Ross and others, this theory postulates that dividend announcements serve as a signal to the market about a firm's profitability and financial stability. Firms with higher and consistent dividends are perceived to be more financially sound, which positively influences stock prices.

Empirical Findings

- **Lintner (1956)** emphasized the role of stable dividends in corporate policy, noting that firms tend to adjust dividends gradually rather than making abrupt changes.
- **Rozeff (1982)** introduced the trade-off between agency costs and transaction costs in dividend decisions. He found that firms with high growth opportunities and external financing needs tend to have lower payout ratios.
- **Sector-Specific Studies:** Banking institutions, due to their regulatory obligations and capital requirements, often use dividends as a strategic tool to attract investors and indicate financial stability. Prior studies have shown that dividend announcements in banking often lead to positive market reactions, especially among private sector banks.

Research Methodology

This study employs a quantitative research design using secondary data for a purposive sample of 12 Indian financial institutions. These include:

- **Public Sector Banks:** SBI, Bank of Baroda, PNB, Union Bank
- **Private Sector Banks:** HDFC Bank, ICICI Bank, Kotak Mahindra Bank, Axis Bank
- **Foreign Banks:** HSBC India, Citibank India
- **NBFCs:** Bajaj Finance, LIC Housing Finance

Data Collection

Data spanning from 2014 to 2024 was collected from:

- Annual Reports of the selected banks
- RBI disclosures and financial bulletins
- National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) market data
- SEBI regulatory disclosures
- Financial portals such as Moneycontrol and Yahoo Finance

Variables

- **Independent Variables:**
  - Dividend per Share (DPS)
  - Dividend Payout Ratio (DPR)
  - Dividend Yield (DY)
- **Dependent Variables:**
  - Share Price
  - Earnings per Share (EPS)
  - Return on Equity (ROE)

Tools Used

- Descriptive Statistical Analysis
- Pearson Correlation Analysis

- Multiple Regression Analysis
- Event Study Method (for HDFC Bank dividend announcement)

Data Analysis and Interpretation

Descriptive Statistics

The average DPS across private banks was significantly higher than public and foreign banks. Private banks such as HDFC and Kotak Mahindra consistently reported higher EPS and ROE, correlating with superior market performance.

Variable	*Mean*	*Median*	*Std. Deviation*	*Max*	*Min*
DPS (₹)	12.4	10.5	6.2	35.0	2.0
Dividend Yield (%)	2.1	1.8	0.9	4.3	0.4
Dividend Payout Ratio (%)	28.6	25.0	13.7	65.0	5.0
EPS (₹)	45.3	41.2	15.4	85.0	15.0

Correlation Analysis

The Pearson correlation coefficient indicated:

- DPS and Share Price: **r = 0.78**
- DPS and EPS: **r = 0.71**
- DPS and ROE: **r = 0.69**

These results suggest that an increase in DPS correlates positively with shareholder wealth indicators.

Regression Analysis

A multiple regression model with Share Price as the dependent variable revealed:

- **DPS ($\beta = 18.5$, $p < 0.01$)** had the highest explanatory power.
- DPR and DY also had positive but comparatively moderate effects.

Event Study: HDFC Bank

Analyzing HDFC Bank's dividend declaration in FY 2023–24 revealed a **5.6% increase in share price** within two days of the announcement, highlighting the signaling effect and strong market confidence in consistent dividend-paying institutions.

Limitations

- Sector-Specific Focus: Concentrating solely on the banking and financial services sector limits the generalizability of findings to other industries.
- Reliance on Secondary Data: The accuracy of the analysis is contingent on the quality and completeness of publicly available financial data.
- Limited to Cash Dividends: The study does not account for alternative forms of shareholder returns, such as share buybacks or bonus issues.
- Time Frame Constraints: Data from 2014 to 2024 may not capture emerging trends post-2024, particularly changes due to digital banking, ESG disclosures, or global economic shifts.

Recommendations

- **Maintain Stable Dividend Policies** – Ensure consistency to boost investor trust.
- **Link Dividends to Performance** – Align payouts with EPS and ROE.
- **Allow Regulatory Flexibility** – RBI should permit dividend flexibility during recovery phases.
- **Use Dividends as a Signal** – Communicate financial strength through dividend announcements.
- **Consider Alternatives** – Explore share buybacks or bonuses when cash is limited.
- **Improve Transparency** – Enhance dividend disclosures in financial reports.
- **Include ESG Factors** – Align dividend decisions with sustainability goals.
- **Apply Predictive Tools** – Use data analytics to model optimal payouts.
- **Educate Investors** – Promote awareness of dividend policy impacts.
- **Benchmark Across Sector** – Use industry comparisons to guide best practices.

Discussion

The empirical results provide substantial evidence in favor of the Bird-in-Hand and Signaling theories. Higher DPS contributes significantly to share price appreciation and overall investor satisfaction, particularly in private sector banks.

Public sector banks, due to government ownership and dividend mandates, show less flexibility in dividend declarations, which often leads to weaker investor responses. NBFCs, with more market-dependent capital models, use dividends to maintain investor loyalty and signal financial health.

Regulatory interventions—like the temporary ban on dividend distributions during the COVID-19 pandemic—highlight the role of external controls in dividend policy. The market response during and after these periods reaffirms that dividend policy carries informational value beyond mere cash returns.

Conclusion

This study confirms that dividend policy plays a significant role in enhancing shareholder wealth in the Indian banking and financial services sector. Among all variables examined, Dividend per Share (DPS) emerged as the most influential, followed by Dividend Payout Ratio (DPR). Dividend Yield (DY) showed a moderate positive influence.

Consistent dividend payments not only satisfy investor expectations but also serve as powerful market signals of firm stability and profitability. These insights are especially relevant in a sector where regulatory compliance and capital retention frequently influence managerial decisions.

Managers must recognize the strategic importance of dividend policy—not merely as a profit-sharing mechanism but as a communication tool that shapes investor sentiment and market valuation.

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