A STUDY ON THE DIVIDEND PRACTICE OF PRIVATE BANKS IN ETHIOPIA

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Statement of declaration

I, the under signed, declare that this project is my original work and has not been presented for a degree in any University, and that all source of materials used for the project have been duly acknowledged.

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Place and Date of Submission: ----------

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Appendix

Interview Guidelines Used

Dear!

This is an effort to collect information about the dividend payment practice of private banks in Ethiopia. I have a plan to study the trend and determinant factors of dividend payment of private commercial banks. Such exercise is believed to have a useful contribution to both academic delivery and practical management of financial resources of businesses in general and private banks in particular.

Therefore, I kindly request you to share with me part of your precious time by giving answers for the questions/guidelines given below.

I thank you in advance!

Yidersal Dagnaw, Msc Student, Accounting and Finance (AAU)

Name of the Bank _____

Position in the bank_____

1. Do you have a policy by which the bank is to be guided to make decisions on dividend payment for the share holders of the bank?
2. Why do you distribute dividend to the stock holders?
    a. to signal information for the share holders as the bank is operating profitably.
    b. Share holders prefer certain dividends than uncertain capital gains.
    c. because it is the excess amount for the bank after financing all positive net present value projects.
    d. if you have reasons other than listed above, please specify
3. Does the ownership structure (Majority and minority share holders) of the bank have any influence on the decision of dividend payment?

4. Do you consider the liquidity of the bank in addition to the profits of the period before decision to pay dividend is made? If so, is there any specified minimum liquidity ratio above which payment of dividend is possible?
5. Do you assess investment opportunities before having decisions on dividend?
6. Do you have target capital structure, so that the dividend payment is dependent on the debt / capital structure targeted?
7. Have you ever paid dividends in the form of
    a. assets other than cash?
    b. stocks / shares?
8. Do you take the tax brackets of investors or share holders of the bank in to account while making decisions on the amount of dividend?
9. Does the variability of earnings have any influence on the dividend payment, just to keep the stability of dividends over time?
10. Do you use dividends to reduce the agency problem that may prevail by reducing the free cash flow that other wise spent on some unprofitable projects by management?
11. Is there any legal restriction over the dividend payment from
        i. Government
        ii. National Bank of Ethiopia (NBE)
        iii. Board of Directors (BOD), to prevent excessive dividend payment?
12. Does the amount of debt of the bank, if any, get consideration while deciding on dividends?

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Abbreviations

AIB – Awash International Bank

BOA – Bank of Abyssinia

DB – Dashen Bank

DER – Debt Equity Ratio

DPS – Dividend per Share

EPS – Earnings per Share

EXL – Liquid Asset in Excess of the reserve requirement

NBE – National Bank of Ethiopia

NIB – Nib International Bank

UB – United Bank

WB – Wegagen Bank

Abstract

The paper examines the trend and determinant factors of dividend payment of the private banks in Ethiopia, where there is no stock market. The study uses data of the six banks for the period from 1999/00 to 2007/08. The study examines the interrelationship between dividend of the banks and some selected key determinants like earnings, debt to equity ratio and liquidity. The findings provide as there is positive linear relationship between dividend per share and earnings per share, dividend per share and debt to equity ratio of the banks. Other determinants like tax considerations, ownership structure, agency problem and legal restrictions are also found to be important determinant factors on the dividend decision of the banks.

A STUDY ON THE DIVIDEND PRACTICE OF PRIVATE BANKS IN ETHIOPIA

Chapter One

1. Introduction

This chapter deals with the back ground of the project, rationale of conducting the project, and the corresponding objectives, significance of the project, scope and limitations of the project and, it deals with how it is organized and presented. The chapter also shows the method of data selection and collection together with the respective methodology used to analyze the data collected.

1.1. Background of the study

The dividend policy of a firm is a significant aspect of corporate financial management, for it has potential implications for share prices (and hence returns to investors), the financing of internal growth (through retentions), the size of the equity base within the firm (again through retentions) and hence it's gearing (leverage) ratio (M. Omran & J. Pointon, 2004).

The topic of dividend policy is one of the most enduring issues in modern corporate finance (Al-Malkawi 2007). This has led to the emergence of a number of competing theoretical explanations for dividend policy. No consensus has emerged about the rival theoretical approaches to dividend policy despite several decades of research.

A range of firm and market characteristics have been proposed as potentially important in determining dividend policy. The attempt to test these competing models and refine them has resulted in a vast empirical literature.

The empirical work on dividend policy has, however, generally been focused on companies operating in countries where there is developed stock markets (Al-Malkawi, 2007).

The examination of dividend policy of companies operating in an environment with no stock markets, until recently has been much more limited. Yet the sorts of firm and market characteristics that may influence dividend policy may in fact be more likely to be present in these companies in an exaggerated fashion than in others. This has provided a central motivation for the present study.

This study seeks to add to that literature by providing a detailed analysis of dividend practice of private banks, share companies, operating in Ethiopia, where there is no stock market.

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1.2. Problem Statement

The dividend payment decision is regarded as one of the most important decisions to be taken from a strategic point of view. Dividend payments affect the level of equity retained in a firm. If the payments are not replaced by issuing new equity securities, the decision also influences the financial structure of the company. The payment of dividend therefore has implications for both investment decisions and financing decisions that are taken. The more cash that a company pays out in the form of dividends, the less funds it has available to finance future attractive investment opportunities and the greater the probability that it will have to issue new shares to raise more capital.

The very reason for the existence of dividend payment is still debatable across researchers in the world of academia. In the world of perfect markets, dividend policy of firms is irrelevant (Miller & Modigliani, 1961). On the other hand, Gordon and Lintner believe stockholders prefer current dividends and that this causes a positive relationship between dividends and market value of firms.

But, in countries like Ethiopia, where there is no capital market, in which investors can sell their share and convert in to cash, at all, the importance of dividend payments by share companies is unquestionable. It is the only and most important means through which investors can realize returns from their investments made with no or at a lower cost.

Having the above points in mind, this project has tried to assess the dividend practice and determinant factors of dividend payments of private banks in Ethiopia.

1.3. Hypothesis Development

The following three hypotheses are developed to be tested, given the absence of stock market in Ethiopia.

Hypothesis1. The amount of dividend of private banks is positively associated with the amount of profit of the respective banks.

The decision to pay dividend starts from the profit of the business. Therefore, it is logical to consider profitability as a threshold factor, and the level of profitability as one of the most important factors that may influence firms' dividend decisions. In his study, Lintner (1956) found that a firm's net earnings are the critical determinant of dividend changes. As written by Al-Malkawi (2007), the pecking order hypothesis may provide an explanation for the relationship between profitability and dividends. That is, taking into account the costs of issuing debt and equity financing, less profitable firms will not find it optimal to pay dividends, ceteris paribus. On the other hand, highly profitable firms are more able to pay dividends and to generate internal funds (retained earnings) to finance investments. Fama and French (2001) interpreted their results of the positive relationship between profitability and dividends as consistent with the pecking order hypothesis.

Hypothesis 2.The amount of dividend of banks is positively related with the liquidity of the banks.

Under normal circumstances, the amount of dividend is expected to tend to increase as the liquidity of the firm increases. Other things being equal, the amount of dividend of banks is expected to increase as the liquidity (measured by the excess of liquid assets over legal reserve requirement) increases, and the reverse is also expected to be true.

Hypothesis 3.The amount of dividend of the banks is negatively related with the amount of debt of the banks.

It is logical to assume that as the risk associated with high degrees of financial leverage increases the amount of dividend to be paid out will decrease because firms need to maintain their internal cash flow to pay their obligations rather than distributing the cash to the share holders. The risk associated with high degrees of financial leverage may therefore result in low dividend payments because firms need to maintain their internal cash flow to pay their obligations rather than distributing the cash to shareholders. Moreover, Rozeff (1982) points out that firms with high financial leverage tend to have low payouts ratios to reduce the transaction costs associated with external financing. Therefore, other things being equal, an inverse relationship between financial leverage ratio, defined as the ratio of total short-term and long-term debt to total shareholders' equity (DER), and dividend is expected (Al-Malkawi, 2007).

1.4. Objective of the Paper

This proposed study, laid its ground on the dividend practice of private banks, has tried to address and fulfill the following general and specific objectives after undergoing a detailed investigation.

- The broad objective of this project was to thoroughly assess the dividend payment practice of private banks in Ethiopia.

The above broad objective can be broken-down in to the following more specific and focused ones. Specifically; the purpose of this project was to achieve the following ends:

- To have a detailed analysis of the dividend payment trend of the private banks
- To clearly identify the determinant factors of dividend payments of the private banks, given the absence of stock market in the country.
- To assess the interrelationship between some selected determinant factors and amount of dividend.
- To know about the dividend policy of the private banks.
- To summarize main findings of the study and forward some suggestions (recommendations) based on the findings, if any.

1.5. Significance of the Paper

The emergency of a number of share companies in different sectors with huge amount of capital raised from institutional and individual investors is the recent phenomenon of businesses in Ethiopia. Investors require returns from these investments. Under the existing situation, the only way for investors to realize returns at a lower or no cost is through the distribution of earnings by the management of share companies. This is because of the absence of capital market in which investors can realize returns in the form of capital gains.

Knowing the dividend payment trend of share companies in the banking industry would be a good insight for the investors and management in all sectors in general, and for the existing and potential investors and management of the banking industry in particular. Moreover, the study could be taken as a reference to take in to account the different determinant factors while having decisions on dividends for the managers of banks and other businesses as well.

Because, to some extent, dividend payment practice in banks may share some important similarities with other sectors, the findings of such a detailed dividend payment practice of private banking industry could form the basis of future comparative research into other sectors in the country.

1.6. Methodology and Sample Selection

1.6.1. Sample Selection

As the title of the project indicates, it is to study the dividend payment practice of private banks; as a result, the sample is confined to the private banks. Even though there are about ten private banks established and start operation following the change in economic policy of the country (1996), the sample is limited to those banks which have paid dividends to share holders at least for five years during their operation. This is because the objectives of the study includes trend analysis and to see the extent to which dividend is influenced by certain financial determinants like profits, liquidity and debt.

1.6.2. Method of Data collection

To achieve the objectives set, both primary and secondary data were employed. Unstructured interviews were conducted with Finance Managers and managers of the share department of the banks.

The data employed in this study were also derived from annual publications and other unpublished materials of the private banks. Brushers, journals and other printed materials of the banks under study were also used as data in this project.

1.6.3. Method of Data Analysis

The paper has used descriptive research methodology and describes the dividend payment trend of the banks over time. Statistical tools like Linear Regression model were also employed to see the association of amount of dividend payment with some of the financial factors, based on which, the hypothesis developed above are accepted or rejected. Furthermore, the trend of dividend payment is presented and described using tables and graphical formats.

1.7. Scope and limitation of the Project

The scope of the project is limited to the analysis and assessment of the dividend payment practice of private banks. The conclusions derived would not be applicable to other share companies in Ethiopia. The findings of the project would have been more important and valuable if some other share companies were included, but due to certain limitations like time, cost, availability of data, etc, dividend paying companies from other sectors are left out.

The project has classified the determinant factors of dividend payment as key financial factors and other determinant factors. Due to the absence of capital market, the influence of some sound financial variables, like price of shares, on dividend were not incorporated in the empirical analysis.

The study is limited to nine years only. Generally twenty years data is ideal to form trend analysis, but I was able to collect nine years annual reports of the six banks under study. This is because the private sector is still at its enfant stage. That is why analysis has been made for nine years only.

1.8. Organization of the Paper

The paper is organized and presented in five chapters. Chapter one is the introductory part and contains the rationale behind having the study, objectives &significance and the methodology used in the paper. Chapter two is all about the discussion on the previous researches in the area. Development and background of the banking industry in general and the private banking sector in particular are highlighted in chapter three of the paper. Detail data presentation, analysis and interpretation are made in chapter four. Chapter five concludes and suggests recommendations based on the findings of the analysis and conclusions derived from the analysis.

Chapter Two

2. Literature Review

In this chapter, important documents necessary for the study were consulted in order to assess what has been done so far in line with the topic. Besides, this chapter serves as a theoretical framework for data analysis and interpretation.

2.1. Overview

Financial and business historians have shown that dividend policy has been bound with the historical development of the corporation. In its modern form, however, dividend policy theory is closely tied to the work of Miller and Modigliani (1961), and their dividend policy irrelevance theory. Miller and Modigliani demonstrate that under certain assumptions including rational investors and a perfect capital market, the market value of a firm is independent of its dividend policy. In actual market practices however, it has been found that dividend policy does seem to matter, and relaxing one or more of Miller Modigliani's perfect capital market assumptions has often formed the basis for the emergence of rival theories of dividend policy. Most financial practitioners and many academics greeted the conclusion of Miller & Modigliani with surprise because the conventional wisdom at the time suggested that a properly managed dividend policy had an impact on share prices and shareholder wealth (Anil & Kapoor, 2008).

Researchers have tried to explain the importance of dividends by looking for the imperfections that can undermine dividend irrelevance proposition. Lintner's (1956) classical study on dividend policy suggests that dividends represent the primary and active decision variable in most situations. He analyzed as to how firms set dividends and concluded that firms have four important concerns. Firstly, firms have long-run target dividend payout ratios. The payout ratio is high in case of mature companies with stable earnings and low in case of growth companies. Secondly, the dividends change follows shift in long-term sustainable earnings (Healy and Palepu, 1988). The managers are more concerned with dividend changes than on absolute level. Finally, managers do not intend to reverse the change in dividends. Fama and Babiak (1968) tests of Lintner's model suggest that it provides a good explanation of how companies decide on dividends rate.

2.2. Theories of Dividend Policy

Since the M& M (1961) study, other researchers have relaxed the assumption of perfect capital markets and offered theories about how dividend affects the firm value and how managers should formulate dividend policy decisions. Over time, the number of factors identified in the literature as being important to be considered in making dividend decisions increased substantially. Thus, extensive studies were done to find out various factors affecting dividend payout ratio of a firm. The setting of corporate dividend policy remains a controversial issue and involves ocean deep judgment by decision makers. There has been emerging consensus that there is no single explanation of dividends. As Nikolaos Eriotis (2005) discussed in his study, a number of empirical and theoretical works have been conducted concerning the different theories of dividend. He summarized all these works, as there are three dominating views. The first one suggests that an increase in dividend payout affects positively the market value of the firm (Gordon 1963, and Lintner1962). The second argues that a positive change in the dividend decreases the firm's value (Lintzenberger and Ramaswamy, 1979). Finally, the third one claims that dividend policy does not affect the market value of the firm Miller and Modigliani (1961). However, the empirical evidence on the determinants of corporate dividend policy is, unfortunately, very mixed (Frankfurter and Wood, Jr. 2002).

2.2.1. The Signaling (information content) Theory of Dividend

This theory is based on the information content of dividends paid by firms to potential and existing investors, and to other stake holders as well. Frank and Wood (2002) explained the theory as, within the framework of problems of asymmetry of information

existing in the heart of the company, the theory of signals defines dividend policy as a signaling mechanism through which internal shareholders, within management, reveal their incentives and private information to external shareholders. This information may modify the value of shares if the announcement of dividends contains relevant information concerning the company's expectations which has not already been discounted by the market. External shareholders reflect in the price of shares the value they attribute to the new information available and express through these variations their degree of conformity with the company's financial policy and the behavior of management (John and Williams, 1985). With better information about the value of their firms than outside investors, managers are likely to face circumstances when they would like to communicate this information to the market, although there are many potentially effective signaling devices to convey such information, a change in dividend choices is a notable candidate (A. kanwer,2003). As written by Al-Malkawi (2007), despite the tax penalty on dividends relative to capital gains, firms may pay dividends to signal their future prospects. The intuition underlying this argument is based on the information asymmetry between managers (insiders) and outside investors, where managers have private information about the current performance and future fortunes of the firm that is not available to outsiders. Ross, *et al*, (1999) wrote as it has been empirically evidenced that the price of a firm's stock generally rises when its current dividend is increased.

2.2.2. Clientele Theory of Dividend

Another closely related theory is the clientele effects hypothesis. According to this argument, investors may be attracted to the types of stocks that match their consumption/savings preferences, that is, if dividend income is taxed at a higher rate than capital gains, investors (or clienteles) in high tax brackets may prefer non-dividend or low-dividend paying stocks, and vice versa (Al-Malkawi (2007), and also, the presence of transaction costs may create certain clienteles. Pettit (1977) presented evidence consistent with the existence of clientele effects hypothesis. Retired investors and pension funds tend to prefer cash income and may therefore want the firm to pay out a high percentage of earnings; on the other hand, shareholders on their peak earnings years prefer the reinvestment of cash and low dividend payments (Wolmarans, 2003). Miller and Modigliani (1961) admit the possibility of clientele effects linked to dividends distributions, but they state that if the distribution of the firms' payout ratios corresponds exactly to the distribution of the investors' preferences, then the situation is not different from the case of perfect markets, where it is irrelevant for investors to receive dividends or capital gains. Each firm will tend to attract its own clientele, constituted by the investors that prefer its payout ratio. Black and Scholes (1974) also recognize the possibility of the existence of a clientele effect. They state that the firms, knowing that there are investors for several types of dividend yields, would adjust their dividend policies as necessary, to satisfy the demand.

2.2.3. The Bird-in-Hand Theory of Dividend

It is a theory for paying dividends based on the idea that since investors are risk-averse, they prefer a stream of relatively certain dividends over uncertain capital gains. Investors think dividends are less risky than potential future capital gains, hence they like dividends. This theory (a pre-Miller-Modigliani theory) asserts that in a world of uncertainty and information asymmetry dividends are valued differently to retained earnings (capital gains). Because of uncertainty of future cash flow, investors will often tend to prefer dividends to retained earnings. As a result, a higher payout ratio will reduce the required rate of return (cost of capital), and hence increase the value of the firm (Gordon, 1959). Miller and Modigliani (1961) point out that the current income argument is not relevant to their theoretical model. According to them, an individual preferring high current cash flow but holding low dividend securities can easily sell-off shares to provide the necessary funds. Thus, in a world of no transaction costs, a high-current-dividend policy would be of no value to the stock holder. However, the current income argument does have relevance in the real world as a result of the presence of transaction costs (Ross, *et al,* 1999).

2.2.4. Pecking Order Theory

As written by Fama & French (2007), Myers (1984) develops an alternative theory known as the pecking order model of financing decisions. The pecking order arises if the costs of issuing new securities overwhelm other costs and benefits of dividends and debt. The financing costs that produce pecking order behavior include the transaction costs

associated with new issues and the costs that arise because of management's superior information about the firm's prospects and the value of its risky securities.

Pecking order can keep leverage of firms down when investments are persistently large relative to earnings, as a result dividend payers can keep their payout ratio low (Fama & French, 2007). Firms that do not pay dividends can refrain from starting when earnings are strong. Fama and French (2001) find that dividend payers tend to be firms with high earnings relative to investment. Thus, for dividend payers, the prediction that firms with larger expected investments have less current leverage.

2.3. Forms of Dividend Payment

The usual meaning of dividend is a distribution of assets to stock holders in proportion to the number of shares of capital stock owned. The assets to be distributed can be in cash form or in some other asset. As alternative to the distribution of dividend in the form of assets, firms may distribute shares of their common stock holders as stock dividends.

The most common type of dividend is in the from of cash. Share companies usually pay regular cash dividends, and some times firms will pay an extra cash dividend in addition to the regular one (Ross, *et al*, 1999).

Many corporations distribute stock dividends to their share holders. As defined by Mosich (1989), a stock dividend is a distribution of additional shares of capital stock called dividend shares, to stock holders in proportion to their existing holdings. It is not a true dividend, because no cash leaves the firm, added Mosich. Rather it increases the number of shares outstanding, thereby reducing the value of each share (Ross, *et al*, 1999). Dividends are not always in the form of cash; frequently companies also declare stock dividends (Brealy and Myers 2000).

Brealy and Myer (2000) added that a stock dividend is very much like a stock split. Both increase the number of shares, but the company's assets, profits, and total value are unaffected so both reduce value per share. The distinction is that a stock dividend is the transfer of retained earnings to equity capital where as a split is a reduction in the par value of each share.

2.4. Determinants of Dividend payments

Over the past several decades, finance scholars have engaged themselves in extensive theorizing about factors that might be important in determining a firm's dividend policies. In developed countries, where there are well developed capital markets, the decision between paying dividend and retaining earnings has been taken seriously by both investors and management, and has been subject of considerable research by academicians. Scholars have also tried to identify the factors influencing the dividend policies and practices of firms. To enumerate, some of these factors are profitability, liquidity, earning predictability, Investment Opportunities, Ownership Considerations (agency cost), cash flows (liquidity), size of firms, amount of debt (leverage), tax considerations, legal considerations of the industry in which the firm is operating, etc.

2.4.1. Profit of firms

Profits have long been regarded as the primary indicator of the firm's capacity to pay dividends. A firm's profitability is considered to be an important factor that affects its dividend amount, this is because profitable firm are willing to pay higher amounts of dividends and hence a positive relationship is expected between firm's profitability and its dividend payments (Al Najjar 2007). This result is also supported by the signaling theory of dividend policy. Lintner (1956) conducted a study on how managers make dividend decisions. According to him the dividend payment pattern of a firm is influenced by the current year earnings and previous year dividends. Baker, *et al*, (1986) had a research and concluded that the major determinants of dividend

payments are anticipated level of future earnings and pattern of past dividends. Pruitt and Gitman (1991) asked financial managers of some of the largest U.S.firms and reported that, current and past year profits are important factors influencing dividend payments. Baker and Powell (2000) conclude from their survey that dividend determinants are industry specific and anticipated level of future earnings is the major determinant. Pandey (2001) suggests that low profitability of Malaysian firms in the trading and services sector is associated with low dividends. Dividend omissions of Malaysian firms are related to negative earnings; whereas, provided earnings are not negative, dividends are likely to either increase or stay the same.

2.4.2. Liquidity (Cash flow Position) of firms

The liquidity or cash flow positions is also an important determinant of dividend payouts. A poor liquidity position means less generous dividends due to shortage of cash. Alli (1993) reveal that dividend payments depend more on cash flows, which reflect the company's ability to pay dividends, than on current earnings, as cited by Anil and Kapoor (2008). They claim current earnings do not really reflect the firm's ability to pay dividends. A high degree of liquidity might be expected to encourage dividends by enabling high dividends to be paid with out resort to external finance (Brittain, 1966). The liquidity of a company is a prime consideration in many dividend decisions, because dividends represent a cash out flow, the greater the cash position and over all liquidity of a company, the greater its ability to pay a dividend (Van Horne and Wachowicz 2005). They added that a company that is growing and profitable may not be liquid due to the increase in fixed assets and permanent working capital, and because the management may also desire to maintain some liquid cushion to give it

financial flexibility and protection against uncertainty, it may be reluctant to jeopardize this position to pay a large dividend. The liquidity or cash flows position is also an important determinant of dividend payouts (Anil & Kapoor, 2008). A poor liquidity position means less generous dividends due to shortage of cash.

2.4.3. Debt (Leverage) of firms

When a firm acquires debt financing it commits itself to fixed financial charges of interest payments and the principal amount, and failure to meet these obligations may lead the firm into liquidation. To reduce such risks, a firm may prefer to retain higher proportion of the earnings rather than paying it in the form of dividend. Rozeff (1982) points out that firm with high financial leverage tend to have low payout ratios to reduce the transaction costs associated with external financing. A firm's leverage plays a key role in explaining firms' dividend policy. Leverage is negatively related to dividends, this means that firms with low debt ratios are willing to pay more dividends. As Aivazian (2003) indicates, firms with relatively less debt and more tangible assets have greater financial slack and more able to pay and maintain their dividends. This result is supported by the agency costs theory of dividend policy. According to the pecking order theory (Myers, 1984) firms should prefer to finance investment by retentions rather than by debt. A higher retention ratio implies a lower dividend payout ratio, so a lower payout ratio should be associated with lower gearing rather than higher gearing. Conversely, a higher payout ratio should be associated with higher gearing. The inverse relationship between amount of debt and dividend is also evidenced by Fama & French (2007). However, contrary to this it is also argued that there is a positive relationship between leverage and a firm's dividend policy. This is supported by the signaling theory of

dividend. As cited by Al Najjar (2007), Firms with high payout ratios tend to be debt financed, while firms with low payout ratios tend to be equity finance (Chang and Rhee, 1990).

Another determining factor affecting the pay out policy of businesses supporting equity financing than debt is the amount of interest payment over the debt. As Brittain (1966) conclude, even if the dividend decision is the primary one, rising interest rates may tend to discourage dividends by making internal finance more attractive. He added dividends would tend to be negatively associated with the cost of debt financing.

2.4.4. Firms size

A firm's size is expected to explain the firm's dividends policy. Large firms are more likely to be mature and thus have easier access to capital markets, and should be able to pay more dividends (Al Najjar 2007). This indicates that, large firms can afford to pay higher dividends than the smaller ones. The empirical findings of Nikolaos Eriotis (2005) suggest that distributed earnings and size of firm include an indication about the firm’s dividend. Besides obtaining a fair idea of dividend pay out ratios in various sectors, Aneel Kanwer (2002**)** investigate the validity of impact of firm size on capital structure and dividend pay out policies in Pakistan.

2.4.5. Investment Opportunities

Businesses with many good investment opportunities have high cash needs, which may lead them to pay out a low fraction of earnings to shareholders as dividends. Alternatively, we could argue that the relation between investment opportunities and dividends is in fact positive. Survey evidence suggests that firms are highly reluctant to

cut dividends and increase dividends only when sustainably higher earnings are expected (Lintner (1956). This conservatism suggests that only firms with a variety of good investment projects pay high dividends today because the cash flows earned from future projects support high dividends in the future(Chay and Jungwon Suh, 2005). The higher the growth opportunities, the more the need for funds to finance expansion, and the more likely the firm is to retain earnings than pay them as dividends (Chang and Rhee, 2003). In addition, this negative relationship is in line with Myers and Majluf (1984) findings. They suggested that firms with high growth opportunities will have low payout ratios. This negative relationship is supported by the agency theory of dividend policy (Chang and Rhee 2001). The idea was implicitly considered by Miller and Modigliani (1961). They stated it as the investment policy of the firm is set ahead of time and is not altered by changes in dividend policy.

2.4.6. Taxes

In situations where income on unrealized capital gains are not taxed, investors usually prefer a low payout, and hence growth. The Miller& Modigliani (1961) theory, which posit on the irrelevance in a tax-less society is remarkable fictitious on its assumption of taxes. Tax is a recurrent factor in most economies. Taxes undeniable affect investors and the firm especially in the dividend policies. As written by Nnadi & Akpomi (2008), when the Miller & Modigliani theory was postulated, most financial practitioners and many academics greeted the conclusion that tax had a marginal effect on dividend policy with surprise (Baker, *et al*, 2001). They added that it is difficult to divorce dividend policy formulation of firms from the tax effect it attracts. Brealey and Myers (2000) in their book stated as if dividends are taxed more heavily than capital gains, investors should

pay more for stocks with low dividend yields. In other words, they should accept a lower pretax rate of return from securities offering returns in the form of capita gains rather than dividends. Tax considerations have obvious potential to influence dividend payments to common shareholders, since dividends trigger tax obligations that might otherwise be deferred or avoided (A.Desai, *et al*, 2001).The influence of tax rates on dividend policy is also indicated in the paper written by Stacescu (2004) as it implies that high marginal tax rate investors could reduce their tax liabilities by selling their shares before the shares go ex-dividend and buying them again afterwards. Investors with a low dividend tax rate will do the opposite.

2.4.7. Risk (variability) of Earnings

Pruitt and Gitman (1991) find that risk (year to year variability of earnings) also determine the firm's dividend policy. A firm that has relatively stable earnings is often able to predict approximately what its future earning will be. Such a firm is more likely to pay a higher percentage of its earnings than firm with fluctuating earnings. A high rate of growth of profits may lead to a reduction of the fraction paid out if corporate officials believe such growth rate may not be maintained (Brittain, 1966). In connection with this one, stability of dividend payments is an attractive feature of many investors; a share of a stock may command a higher price if it pays a stable dividend over time than if it pays out a fixed percentage of earnings (Van Horne and Wachowicz 2005).

A firm with stable earnings can predict its future earnings with a greater accuracy.

Thus, such a firm can commit to paying larger proportion of its earnings as dividends with less risk of cutting its dividends in the future (Chang and Rhee, 2001).

2.4.8. Agency Problem

The agency costs argument is based on the assumption that managers may conduct actions in accordance with their own self-interest which may not always be beneficial for shareholders. Al-Malkawi (2007), discussed in his study the importance of dividend payments to reduce the agency problem as follows. The agency costs thesis predicts that dividend payments can reduce the problems associated with information asymmetry. Dividends may also serve as a mechanism to reduce cash flow under management control, and thus help to mitigate the agency problems. Reducing funds under management discretion may result in forcing them in to the capital markets more frequently, thus putting them under the scrutiny of capital suppliers (Rozeff, 1982, and Easterbrook). As indicated by Kowalewski, *et al,* (2007), the agency theory points that dividends may mitigate agency costs by distributing free cash flows that otherwise would be spent on unprofitable projects by the management (Jensen, 1986). This scrutiny by the markets helps alleviate opportunistic management behavior, and, thus, agency costs Kowalewski, *et al*, (2007). The result of their research conducted in Poland supports the hypothesis that in companies providing strong minority shareholder rights, the power is often used to extract dividends, especially when investment opportunities are poor, and as a result, companies with weak shareholder rights pay dividends less generously than do firms with high corporate governance standards. Easterbrook (1984) argues that dividends help alleviate agency conflicts by exposing firms to more frequent monitoring by the primary capital markets because paying dividends increases the probability that new common stock has to be issued more often.

2.4.9. Regulatory Considerations

The regulation environment of industries in which companies are operating might have specified requirements concerning the amount of distributions of earnings in the form of dividends. The banking industry is one of the most regulated in most of the countries due to its importance in intermediation of business units with excess funds with that of shortage of funds. As Van Horne and Wachowicz (2005) put in their book the laws of a firm's state of incorporation decide the legality of any distribution to common share holders. As provided in the literatures the influence of the legal system on dividend payments might result to one of the following forms.

- ✓ Restrictive covenants in bond indentures, loan agreements, and preferred stock agreements.
- ✓ Designed to prevent excessive payments of dividends.
- ✓ No Dividends Unless Earnings or Net Assets reach certain levels.
- ✓ Net profit rule or Capital impairment rule.
- ✓ Insolvency rule- insolvent firms cannot pay dividends

A research carried out by K. Baker (2005), cited in Shleifer and Vishny (1997) conclude that the legal protection of investors and some form of concentrated ownership are essential elements of a good corporate governance system.

Chapter Three

3. Historical Development and Backdrop of the Banking Industry

In this chapter, the historical development of the banking industry in Ethiopia, starting from its birth to the current status, has briefly discussed. For the purpose of discussion, the banking history of the country has been categorized in to three periods, (pre-Dergue period, during the Dergue period and post-Dergue period).

3.1. The Birth of Banking Service in Ethiopia (Pre-Dergue period)

It was in 1905 that the first bank, the "Bank of Abyssinia", was established based on the agreement signed between the Ethiopian government and the National Bank of Egypt, which was owned by the British. Its capital was 1 million Shillings. According to the agreement, the Bank was allowed to engage in commercial banking (selling shares, accepting deposits and effecting payments in checks) and to issue currency notes. The agreement prevented the establishment of any other bank in Ethiopia, thus giving monopoly right to the Bank of Abyssinia. The Bank, which started operation a year after its establishment agreement was signed, opened branches in Harar, Dire-Dawa, Gore and Dembi-Dolo as well as an agency office in Gambela and a transit office in Djibouti. Apart from serving foreigners residing in Ethiopia, and holding government accounts, it could not attract deposits from Ethiopian Nationals who were not familiar with banking services.

The Ethiopian government, under Emperor Haile Sellasie, closed the Bank of Abyssinia, paid compensation to it share holders and established the Bank of Ethiopia which was fully owned by Ethiopians, with a capital of Pound Sterling 750,000. The bank started operation in 1932. The majority share holders of the Bank of Ethiopia were the Emperor and the political elites of the time. The Bank was authorized to combine the functions of central banking (issuing currency and coins) and commercial banking. The bank of Ethiopia opened branches in Dire Dawa, Gore, Dessie, Debre Tabor and Harrar.

With the Italian occupation (1936-1941), the operation of the Bank of Ethiopia came to a halt, but a number of Italian financial institutions were working in the country. These were Banco Di Roma, Banco Di Napoli and Banca Nazionale Del Lavoro. It should also be mentioned that Barclays Bank has opened a branch and operated in Ethiopia during 1942-43.

In 1943 Banque Del Indochine was opened and functioned until 1963. In 1945 The Agricultural Bank was established but was replaced by the Development Bank of Ethiopia in 1951, which changed in to the Agricultural and Industrial Development Bank in 1970. In 1963, the Imperial Savings and Home Ownership Public Association (ISHOPA) and the Investment Bank of Ethiopia were founded. The later was renamed Ethiopian Development Corporation S.C. in 1965. In the same year, the savings and Mortgage Company of Ethiopia S.C. was also founded.

With the departure of the Italians and the restoration of Emperor Haile Selassie's government, the State Bank of Ethiopia was established in 1943 with a capital of one million Maria Theresa Dollars by a charter published as General Notice No. 18/1936(EC). The Bank which, like its predecessor, combined the functions of central

banking with those of commercial banking opened 21 branches, including one in Khartoum (the Sudan) and a transit office in Djibouti(*AIB & AIC, 10th Anniversary Special Publication).*

The National Bank of Ethiopia with more power and duties started its operation in January 1964. Following the incorporation as a share company on December 16, 1963 as per proclamation No.207/1955 of October 1963, Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia. It started operation on January 1, 1964 with a capital of Eth. Birr 20 million.

The first privately owned company in banking business was the Addis Ababa Bank S.C., established in 1964. 51% of the shares of the bank were owned by Ethiopian Share Holders, 9% by foreigners living in Ethiopia and 40% by the National and Grindlays Bank of London. The Bank carried out typical commercial banking business. Banco Di Roma and Banco Di Napoli also continued to operate.

Thus, up until the end of 1974, there were state owned, foreign owned and Ethiopian owned banks in the country. The banks were established for different purposes: central banking, commercial banking, development banking and investment banking. Such diversification of functions, lack of widespread banking habit among the wider population, the uneven and thinly spread branch network, and the asymmetrical capacity of banks, made the issue of competition among banks almost irrelevant (*NBE: http:// www.nbe.gov.et, and AIB & AIC, 10th Anniversary Special Publication).*

3.2. Banking Services during the Dergue Period

On January 1, 1975 all private banks were nationalized and, along with state owned banks, placed under the coordination, supervision and control of the Nationa Bank of Ethiopia. The three private banks, Banco Di Roma, Banco Di Napoli and the Addis Ababa Bank S.C. were merged to form "Addis Bank". Eventually in 1980 this bank was itself merged with the Commercial Bank of Ethiopia S.C. to form the "Commercial Bank of Ethiopia", thereby creating a monopoly of commercial banking services in Ethiopia.

In 1976, the Ethiopian Investment and Savings S.C. was merged with the Ethiopian Government Saving and Mortgage Company to form the Housing and Savings Bank. The Agricultural and Industrial Development bank continued under the same name until 1994 when it was renamed Development Bank of Ethiopia.

Thus, from 1975to 1994 there were four state owned banks, namely the National bank of Ethiopia (the central bank), the Commercial Bank of Ethiopia, the House and Savings Bank and the Development Bank of Ethiopia(*NBE: http:// www.nbe.gov.et, and AIB & AIC, 10th Anniversary Special Publication).*

3.3. Banking Services: Post-Dergue Period

After the overthrown of the Dergue regime by the EPRDF, the transitional Government of Ethiopia was established and the New Economic Policy for the period of transition was issued. This New Economic Policy replaced centrally planned economic system with a market oriented system and ushered in the private sector. Following the change in the economic policy, financial sector reform also took place.

Monetary and Banking Proclamation of 1994 established the National Bank of Ethiopia as a judicial entity, separated from the government and outlined its main functions. Monetary and Banking proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994 laid down the legal basis for investment in the banking sector. Consequently shortly after the proclamation the first private bank, Awash International Bank was established in 1994 by 486 shareholders and by 1998 the authorized capital of the Bank reached Birr 50.0 million. Dashen Bank was established on September 20, 1995 as a share company with an authorized and subscribed capital of Birr 50.0 million. Bank of Abyssinia, another private bank was founded by 131 shareholders with subscribed and authorized capital of 25.0 million and 50 million, respectively. Wegagen Bank with an authorized capital of Birr 60.0 million started operation in 1997. The fifth private bank, United Bank was established on 10th September 1998 by 335 shareholders. Nib International Bank also started operation on May 26, 1999 with an authorized capital of Birr 150.0 million. Cooperative Bank of Oromia was established on October 29, 2004 with an authorized capital of Birr 22.0 million. Lion International Bank with an authorized capital of Birr 108 million started operation in October 02, 2006. The ninth bank, Zemen Bank started operation on June 17, 2008 with an authorized capital of Birr 87.0 million. The last bank to be established to date is Oromia International Bank that started operation on September 18, 2008 with an authorized capital of Birr 91 million *(NBE: http:// www.nbe.gov.et, and AIB & AIC, 10th Anniversary Special Publication).*

3.4. Private Banking Sector

Currently, there are about ten private banks rendering commercial services for the public at large. As studied by Gebrehiwot Ageba (2008), in 2006/07, the private banks had 232branches all over the country, and they had a total paid up capital of Br.2.9 billion (compared to 255 branches and a paid up capital of Br.6.3 billion of the three public banks). Private Banks thus account for about 31.5% of the total banking capital and 47.6% of the total branches. He added that the development of private banks in deposit mobilization was essentially dynamic- their deposits increased 33.5%per year on average, compared to annual deposit increase of 9.4%in public banks. Despite the dynamic performance of private banks, however, the public banks still have a dominant position, holding about 70.6% of total deposits at end of June 2007. The market share of public banks in total outstanding loans is still higher than that of private banks although it has dropped continually, from 95% in 1998 to 67% in 2006/07.

Of the private banks currently operating, this project has focused on the dividend payment practice of the six large banks for the reason discussed in chapter one of the paper. The year of establishment and the current paid-up capital of these banks can be summarized in the following table.

Table1. Year of establishment & paid up capital

Bank	Year of establishment	Paid-up capital (Sene30,2008)
Abyssinia	1996	312,257,450
Awash	1994	282,300,878*
Dashen	1995	453,993,000
Nib	1999	416,901,000
United	1998	330,277,074
Wegagen	1997	370,825,000

*as of December 31, 2007

Source: NBE & annual reports of the banks

As shown in the table, these banks were not established in the same year and didn't join the market in the same period. This difference in the year of establishment and duration in operation might have its own impact on the dividend pay out of the banks. The authorized and paid up capital of the banks might also have its own influence on the dividend trend of the banks. Given these limitations, the following chapter (chapter four) presents an analysis on the determinant factors and dividend payment trend of the six banks.

Chapter Four

4. Data Presentation, Analysis and Interpretation

This chapter is divided in to four main sections. In the first section, reasons why the banks pay dividends are described. In the second section, the dividend policy and the form of dividend payment of the banks have been briefly described based on the interviews conducted with the responsible individuals in each of the banks.

The third section contains the dividend payment trend of the banks during the nine years. And the trend is presented and described using tables and charts.

Included in section four of the chapter is the details of the determinant factors of dividend payment of the banks under study in two subsections. The first subsection deals with the degree of the association of some selected financial determinants of dividend payments, given the economic and data accumulation system of the country in general and the banking industry in particular, using regression models. Data from the annual reports of the six banks (1999/00-2007/08) were used to get the regression output. The second subsection contains discussions on other determinant factors through the analysis of documents and data collected through interview with the responsible officials of the banks under study.

4.1. Why the Private Banks pay Dividends?

Miller and Modigliani (1961) argue that given perfect capital markets, the dividend decision doesn't affect the value of the firm, and is therefore irrelevant. For a firm operating in an environment where there is no capital market at all, forget the perfect one, like ours, importance of dividend payment is not to be forwarded for discussion. The same is true for private banks in Ethiopia. The central issue is how decision on dividend is made and what factors need to be considered in the decision of dividends.

An unstructured interview was conducted with the responsible officials of the banks under study concerning the reasons behind paying dividends. During the discussion conducted with these officials of the banks, it was disclosed that there is no option to show for the investors that the operating performance of the bank is good or profitable other than distributing profits in the form of dividend. This is due to the absence of capital market in the country, where share holders can realize returns from their investments made on the banks even in the absence of declaration of dividend. Had a stock market been operational, the profitability of the banks would have been reflected in the price of the stocks in the market, and any dividend accrued would have been incorporated there as capital appreciation.

The respondents added that under the current business environment prevailing in Ethiopia there are no professional firms (individuals) that undertake financial analysis. These firms would have made analysis on share companies which can confirm whether the company is operating profitably or not and the price of shares would have reflected the inherent value of the company. There is no stock market

where an investor willing to transfer shares to other parties can negotiate on the price and sell it. The stock market is highly illiquid in general. Hence, dividend payment is the only available means to inform the share holders as their wealth is increasing as a result of the investment made on the bank. All these factors made the distribution of dividend a message for the share holders that the bank is operating profitably. This leads to a conclusion that the dividend practice of the banks supports the signaling theory of dividend.

On the other hand, after the General Assembly decides on the amount of dividend (indicated above), a form is used to be distributed by the bank to know the preference of each share holder how much of the dividend that he/she is interested to take in the form of cash and how much is to be capitalized (stock dividend), given the limitation over the number of shares that each share holder is allowed to enjoy. This means that one, who prefers certain cash dividends than uncertain increase in investment from the share of the bank, can take the cash dividend. This practice supports the Bird-in-hand theory of dividend.

How Decision on Dividend is made in the banks?

Banks prepare financial statements at the end of each year and determine their operating results. After total amount of after tax net profits distributable to the share holders is determined, the Board of Directors of the banks prepares proposals on the amount dividend payment at the end of each year. The board presents the proposal to the General Assembly, and after having detail discussion, the Assembly makes decisions on the distribution of earnings as per the articles of association of the banks as per the articles of association of the banks.

4.2. Policy and Forms of Dividend Payments of the Banks

The private banks do not have separately written dividend policy by which they are to be guided while making decisions on dividend except the one indicated in their articles of association. The articles of associations of the banks indicate that the General Assembly is the final decision maker on dividend of the banks at the end of each financial year.

Once the amount to be distributed is decided (as indicated above), it is the preference of the individual share holder to take in cash or to capitalize his share in the bank by taking additional shares instead of cash dividend, although there is a limitation on the number of new shares to be issued for the dividend. A study at Awash International Bank shows that about 70%of the shareholders reinvest their dividend in the bank (stock dividend), about 17% took cash dividend and the remaining 13% preferred partially in cash and partially in the form of dividend during the life of the bank. The same is true in other banks though there is no study made, as per the respondents. Before the issuance of banking business proclamation No. 592/2008, this was the experience of banks. But now article 11of the proclamation restricts a share holder other than the Federal Government of Ethiopia, not to own more than 5% of the capital of the bank as against the previous rate of 20%, as stated in article 13 of Proclamation No. 84/1994. It is expected that some of the share holders may be obliged to take the cash dividend in the future, because if allowed to take stock dividend instead of cash, their capital may go up beyond the 5% limit.

It is also found that during the nine years no bank paid dividends in the form of assets other than cash and share dividends.

4.3. Analysis of Dividend Payment Trend of the Banks

To see the dividend payment trend of each bank and across the banks, the dividend per share of the banks for the period from 1999/00 to 2007/08 has been computed. Since the reporting period of Awash international Bank is different from others (Jan 1- Dec31), the period covered for this bank in the study is from 1999 to 2007. The financial (reporting) year for all other five banks is from July1 to June30. The par value of the shares of the banks differs from bank to bank. The shares of Abyssinia Bank have a par value of Br.25, Awash international Bank Br. 1000, Dashen bank Br.1000, Nib international Bank Br.500, United bank Br. 100, and Wegagen bank Br.1000. For the purpose of comparison in analyzing the dividend payment trend of these banks, the dividend per share and the respective earnings per share of the banks with par value different from Br 1000 are recomputed as if the shares have par value of Br 1000, so that comparison of the dividend per share across the banks during the period under study is made simple and consistent.

As it is provided by so many literatures and also empirically evidenced in section 4.4. of this chapter, earnings per share is found to be the most important determinant factor of dividend per share. As a result of that, trend of the dividend per share of the banks is presented in tabular forms and analyzed using charts together with the earnings per share of those banks during the period.

The following table depicts the earnings per share and dividend per share of the banks during the period.

	Abyssinia	Awash*	Dashen	NIB	United	Wegagen

Year	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS
1999/00	76	177	183	197	113	248	0	230	0	76	32	78
2000/01	70	172	87	189	100	430	0	254	41	89	54	134
2001/02	103	-19	117	209	300	476	118	214	55	55	141	125
2002/03	0	42	115	94	267	354	82	142	35	63	77	177
2003/04	0	284	100	157	411	608	81	296	45	78	167	380
2004/05	189	403	178	279	460	712	172	320	56	347	202	478
2005/06	187	430	223	302	537	956	185	322	205	416	261	553
2006/07	247	250	379	529	692	1,001	170	320	178	359	261	573
2007/08	173	58	355	526	566	846	153	322	192	295	254	449

Table 2. DPS and EPS of the six banks during the period

*period covered is 1999-2007

Source: summarized from Annual reports of the banks

As can be seen from the table above, the dividend per share of banks range from the minimum zero (BOA in 2002/03 &2003/04, NIB in 1999/00 & 2000/01, and UB in 1999/00) to a maximum dividend per share of Br.692 by DB in 2006/07. The earnings per share of the banks during these periods were Br 42 & 284 in 2002/03 &2003/04 respectively for BOA, Br. 230 & 254 in 1999/00 & 2000/01 respectively for NIB, and Br. 76 for UB in 1999/00. The earnings per share of the banks during the same period range from a minimum per share loss of Br.19 to (BOA in 2001/02) to a maximum earnings per share of Br. 1001 (DB in 2006/07). Unexpectedly, bank of Abyssinia paid dividend per share of Br. 103 in 2001/02 when it recorded negative earnings per share.

The maximum dividend per share paid during the period by each of the banks was Br.247,355,692, 185, 205 & 261 by BOA, AIB, DB, NIB, UB & WB respectively, and the minimum dividend per share was 0, 87,100, 0,0 & 32 respectively.

To see the trend analysis of average dividend per share of the banks vertically, the following table (table 3) is developed. The table shows the average dividend per share

of the banks during the period under study and the percentage change in dividend per share in the same time period together with the respective earnings per share.

The maximum percentage increment in the average dividend per share of the private banking sector was in the year of 2004/05, increased by 56% (from 134 to 210 per share), on the other hand, the average earnings per share of the banks during the same period was increased by 41 %(from 301 to 423 per share) which is the maximum increment in earnings per share during the period.

Table 3: percentage change in average Dps & Eps

Year	Aver Eps	Change	Aver Dps	Change
1999/00	168		67	
2000/01	211	0.26	59	-0.13
2001/02	177	-0.16	139	1.37
2002/03	145	-0.18	96	-0.31
2003/04	301	1.07	134	0.40
2004/05	423	0.41	210	0.56
2005/06	497	0.17	266	0.27
2006/07	505	0.02	321	0.21
2007/08	416	-0.18	282	-0.12

Source: summarized from Annual reports of the banks

The trend analysis of the average dividend per share of the private banking industry during 1999/00-2007/08, together with the respective earnings per share, presented in the above table can be seen using charts as follows.

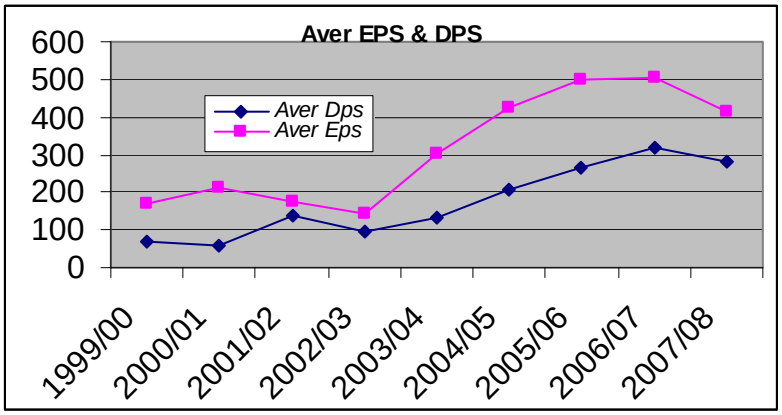

Fig. 1: Average earnings per share and dividend per share

During the first four years, 1999/00-2002/03, there was no clearly identified trend both in the dividend per share as well as earnings per share. During the next four years (2003/04-2006/07), the graph shows an increasing trend both in the dividend per share and earnings per share. In the year of 2007/08, it shows a slight decrease in both the earnings per share and the dividend per share. In general, it is apparent to conclude that the trend of dividend per share is parallel to the trend of earnings per share except the year 2001/02 in which earnings per share and dividend per share go in opposite directions. This conclusion is substantiated by statistical analysis in subsection 5.4.1 of the chapter.

The horizontal analysis of dividend payment of the private banking industry can be analyzed by taking the average dividend per share of each bank during the period covered.

Table 4. Average Dps and Eps

Bank	Eps*	Dps*	percent
Abyssinia	200	116	58.13
Awash	276	193	69.98
Dashen	626	383	61.21
Nib	269	107	39.77
United	198	90	45.43
Wegagen	327	161	49.18
*average			

Source: Computed from table 1

As shown in the above table, the maximum average dividend per share during the period is paid by Dashen bank amounting Br 383 (61% of the earnings), followed by Awash Bank and Wegagen bank which paid average dividend per share of Br. 193(70%) and Br.161 (49%) respectively. The minimum payment was made by United bank amounting Br. 90(45%) per share, followed by Nib bank and Bank of Abyssinia with a payment of Br. 107(40%) and Br.116 (58%) per share on average respectively. The following chart shows the average dividend per share of each bank under study with the corresponding earnings per share during the nine years.

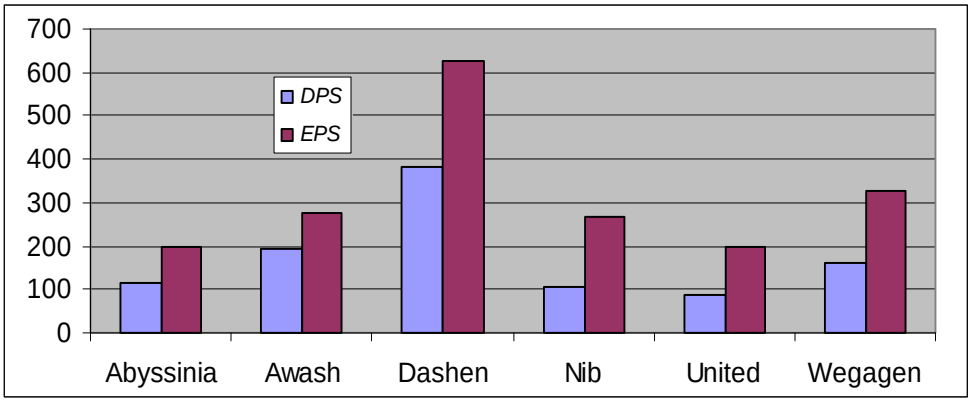

Fig 2: Average Dps and Eps

The graph clearly indicates that the highest average earning per share was recorded by Dashen bank (Br.626), and it was also true for dividend (Br.383) during the period covered.

The accumulated dividend and earnings (net profit after tax), and the proportion of the total earnings paid out in the form of dividend for all the banks under study during the nine years is shown below. One can see from the table that Awash International Bank has paid the highest proportion of its earnings in the form of dividend (69.45%) followed by Bank of Abyssinia and Dashen bank which paid 68.23% and 64.09% of their earnings recorded during their operation in the nine years respectively. Dashen bank is the highest in the amount of accumulated earnings, and United Bank is the lowest both in the amount of earnings and dividends but NIB is the lowest in the proportion of earnings paid out in the form of dividend (48.18%).

Table 5. Total dividend and total earnings

Bank	Total earnings	Total Dividend	Percent
BOA	304,443,756	207,717,705	68.23
AIB	366,730,751	254,683,876	69.45
DB	770,798,877	494,000,000	64.09
NIB	364,744,963	175,747,561	48.18
UB	253,604,525	130,524,266	51.47
WB	427,231,735	212,705,023	49.79

Source: summarized from Annual reports of the banks

UB and WB lay in between these by paying 51.47% and 49.79% of their after tax net profit in the form of dividend during the nine years respectively. In general, the banks have paid around 58.5% of their profit as dividend on average in the nine years.

This total earnings and the portion paid in the form of dividend can be seen by using charts as given below (Fig 3).

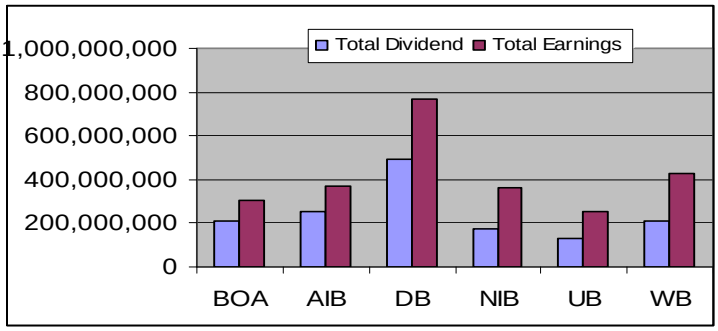

Fig 3. Total Dividend and total earnings during the nine years

The variation in the amount of the proportion of earnings paid out across the banks in the form of dividend results from the earnings of the banks and the nature shareholders. Some banks can have more feasible investment projects than others, so that they pay lower proportion of earnings than others. The preference of the shareholders itself causes dividend to vary across the bans. The shareholders of some banks may need immediate cash flow from the investment made on the banks, and others may not. After all, it is the decision of the shareholders on the general assembly whether to withdraw the earnings in the form of dividend or not. The duration of the banks in the industry is also another cause of variation of earnings paid as dividend. Relatively mature banks pay higher portion of earnings as dividend than others.

4.4. Factors Determining the Dividend payment of the Banks

This section is classified in two subsections. The first subsection is merely of statistical taking some key determinants of dividend. The second subsection is a discussion on other factors from documentary analysis like commercial code of Ethiopia, proclamations, regulations and directives and from the interviews conducted with the officials of the banks.

4.4.1. Key Financial Determinant Factors

This part of the study of factors affecting dividends of banks relies primarily on statistical tools. Given the economic environment of Ethiopia (absence of stock market) and data accumulation culture and willingness of the firms (non-availability of data), the statistical test is limited to the three factors. Regression models have been fitted to annual data for the year specified above in an effort to see whether there is association (positive or negative) between the amount of dividend and the identified variables, average earnings per share, average debt to equity ratio, and liquidity.

4.4.1.1. Data and Variable construction

As per the available literature, the three variables identified above are found to be the key determinant factors in the decision of managers on the payment of dividend to the share holders, though they are not all inclusive and the only ones. To statistically test whether there is close association between the above identified variables and the dividend per share of the private banking industry, cross sectional data of the six

banks have been taken for the period 1999/00-2007/08. The above mentioned variables are identified and computed as follows:

Dividend Per Share (DPS)- to measure the average dividend per share of each bank, the amount of dividend paid by each bank during the nine years have been extracted from the annual reports of the banks.

The dividend is then divided by the average number of shares outstanding (as per the calculation of the banks) during each year to get the dividend per share of banks. The average of the dividend per share of the banks during the nine years is then taken as a proxy variable for the amount of dividend.

Earnings Per Share (EPS) - This one are calculated in the same fashion as to that of the dividend per share. The earnings per share of all the banks are taken from the annual reports of each bank during the period under study. It is disclosed there in the reports as it is computed as the net profit after tax of each year is divided by the average number of shares outstanding during each year. Then, the average of the earnings per share for each bank during the period is taken as proxy variable for profitability to test its association with the amount of dividend across the banks.

Debt to Equity Ratio (DER) - The total liability of each bank as of the date of the financial statements is taken from the reports during each of the nine years. The sum of short term and long term liability is then divided by the total stock holder's equity of the bank as of the same date. The average of this ratio for each bank during the period is taken as debt to equity ratio to measure its association with the amount of dividend across the six banks.

Liquidity of the Banks- As per the Reserve Requirement Directive No. SSB/45/2008, all banks are required to maintain in their reserve account 15% of all Birr and foreign currency deposit liabilities held in the form of demand (current) deposits, saving deposits and time deposits. Considering this fact, the excess of all liquid assets over the legal reserve is computed and divided by the average number of share outstanding during each of the nine years for each bank. The average excess liquid asset per share of the individual banks is then computed and considered as a proxy variable to see the association of liquidity with that of dividend across the banks.

Liquid assets include cash on hand, Reserve and payment and settlement accounts with the National Bank of Ethiopia, deposits with local banks and deposits with foreign banks as per the definition of liquid asset given in the Banking Business proclamation No.592/2008.

Hypothesis and the Variables

The hypothesis to be tested have already been developed in chapter one of the paper. The following table summarizes the hypothesis, variables and the expected association between the dependent variable and the independent variables.

Table 6. Summary of Hypothesis and Variables

Hypothesis	**Variables**	**Relationship with dividend per share**
$H_{1:}$ Earnings per share	EPS: average after tax earnings per share	Positive
H_2: Financial leverage	DER: average debt to equity ratio	Negative
H_3: Liquidity	EXL: Average excess liquid asset per share	Positive
Dependent Variable	DPS: Average dividend per share	

The table below is a summary of the amount of average dividend per share of the banks during the period and the corresponding figures for the above mentioned key variables. This data is used to conduct a statistical test to accept or reject the hypothesis developed.

Table 7. Summary of DPS, EPS, DER & EXL

	Variables			
Bank	DPS	EPS	DER	EXL
BOA	116.06	199.64	7.27	2158.00
AIB	193.00	276.00	9.82	1477.19
DB	382.89	626.00	14.20	5939.85
NIB	106.94	268.89	4.16	2898.28
UB	89.77	197.60	4.99	2328.51
WB	161.00	327.00	7.86	3404.75

Source: Computed with the data obtained from table 1

The variables that have been identified can be stated as follows:

Y= average dividend per share

X_1= average earnings per share

X_2= average debt to equity ratio

X_3= average liquid asset per share

The statistical technique of regression was used to explore the relation ship between these variables.

4.4.1.2 Empirical Analysis of the Data

For the analysis of cross sectional data for the six banks covering the period of 1999/00-2007/08 the technique of multiple linear regression analysis was used. An attempt was made to develop a multiple regression equation using identified key variables. The dividend per share(Y) was used as dependent variable and other variables(X_1, X_2, and X_3) were used as independent variables. On this basis the under mentioned multiple linear regression equation was developed.

$$Y= a +b_1X_1+b_2X_2+b_3X_3 + Error\ Term$$

Where, *a* is the regression constant and b_1, b_2, and b_3 are regression coefficients respectively, and the Error Term is the variation in Y not accounted by the independent variables in the equation.

The regression coefficient indicates the amount of change in the value of dependent variable for a unit change in independent variable. The coefficient of $X_1(b_1)$ measures the change in the mean value of Y per unit change in X_1, holding X_2 and X_3 constant. Likewise, b_2 measures the change in the mean value of the dependent variable-y per unit change in the independent variable-X_2, holding constant X_1 and X_3. In other words, the

coefficient gives the direct or net effect of a unit change in the independent variable-X_1 on the mean value of the dependent variable-Y, net of X_2 and X_3.

To test the significance of any individual partial regression coefficients, t-test has been used. The null hypothesis in this case is that, holding X_2 and X_3, X_1 has no linear influence on Y. If the computed t-value is greater than the critical t-value at a given level of significance, we may reject the null hypothesis and conclude that the independent variable-X_1 has linear influence on the dependent variable-Y, we can say that b_1 is statistically significant, that is, it is statistically different from zero. Likewise, t-test has been conducted on other partial regression coefficients.

The level of significance shows us the probability of rejecting the true null hypothesis. In connection with this, it is also possible to decide whether the individual regression coefficients are statistically different from zero or not by looking at the probability value of the calculated t-value to fall in the rejection region. The p-value is then compared with that of the level of significance assumed. If p-value is less than the level of significance assumed, we can reject the null hypothesis and conclude that the coefficient is statistically different from zero.

The coefficient of determination (R^2), gives an estimate of the proportion of variance of dependent variable accounted for by the independent variable. It suggests the covariance between changes in dividend per share and other independent variables. The value of R^2 varies between 0 and 1. An R^2 of zero means that the predictor accounts for none of the variability of "Y" by "X". An R^2 of 1 means perfect prediction of y by x and that 100% of variability of "Y" is accounted for by "X". The higher the value of R^2, the closer the relationship between the variables.

Regression Results

To see the linear association of the key determinant factors with dividend, regression analysis was performed. The result is given in the following tables.

Table 8: Regression results

R	R Square	ADJ R Square	STD. Error
0.9980	0.9961	0.9902	10.78

Table 9: Regression Coefficients and their significance

	Regression Coefficients	t-value	Prob.
Constant	-53.16456	-3.95	0.058
X_1 (EPS)	0.5386004	3.28	0.082**
X_2 (DER)	11.77145	3.29	0.081**
X_3 (EXL)	-0.0121213	-1.05	0.403

**significant at 10%

Table 10: ANOVA Result

Source	SS	D.o.F	MS	F-Value	Prob.
Model	58877.8186	3	19625.9395	168.89	0.0059*
Residual	232.411054	2	116.205527		
Total	59110.2296	5	11822.0459		

*significant at 5%

The regression result shows that the coefficient of X1 is 0.5386. To see whether this coefficient is statistically significant or not, we can compare the t-value given in the computer output and the critical t-value in the t-table. The calculated t-value is 3.28 greater than the critical t-value 2.353 at 10% level of significance. This leads us to

conclude that the earning per share has a positive linear influence on the dividend per share of the banks. The p-value in the regression output measures the exact probability of rejecting a true null hypothesis, in other words, it is the lowest significant level at which a null hypothesis can be rejected. The p-value in the regression output shows 0.082 which is less than 10%, and we can conclude that the coefficient is statistically significant at 10% significant level.

The coefficient of X_2 in the regression result is found to be 11.77145. The calculated t-value 3.29 is greater than the critical t-value 2.353. This leads to the conclusion that the null hypothesis that b_2 is equal to zero is rejected and to say that debt to equity ratio has a positive linear influence on the dividend per share of the banks during the period under study. The p-value is also found to be lower than the 10% significance level assumed and gives the same result of rejecting the null hypothesis that the coefficient of X_2 is equal to zero and conclude that the coefficient is statistically significant. This significant positive linear influence of debt to equity ratio on the dividend of the banks leads tells us that the banks tend to pay dividends as liability increases, and increase the stockholders equity as individual shareholders reinvest(stock dividend) as per their preference, so that, it enhances the capital adequacy of the banks.

As opposed to the two coefficients b_1 and b_2 (coefficients of X_1 and X_2), b_3 (the coefficient of X_3) is found to be statistically insignificant with a computed t-value of -1.05, lower than the critical t-value of 2.353 at 10% level of significance. This leads us to accept the null hypothesis that the coefficient of X_3 is zero. The p-value of 0.403 also reveals the same result sine it is greater than the 10% level of significance. This result tells us that the liquidity status of the banks has no linear statistical influence on the

dividend payment of the banks. The possible reasons, as indicated by the finance officials of the banks and also from the financial reports, for the absence of this linear relationship are discussed as follows; since the major proportion of the financial resources of the banks is liquid asset, and the amount of the asset required to pay dividends is very less as compared to the total liquid asset, as a result banks may not give attention on their liquidity status to decide on the dividend payment. In addition, the banks know from their experience that most of the share holders prefer to reinvest their dividend in the banks (stock dividend), because of lack of other investment opportunities, possibly due to the absence of stock market in the country. This reinvestment of the dividends in the banks will not result in liquidity problem. These can be taken as the possible reasons for the absence of the linear relationship between liquidity of the banks and dividend per share during the period.

To test the overall significance of the regression model, the analysis of variance approach (ANOVA) was used; the F-test. The null hypothesis in this approach is that, the coefficients of X_1, X_2 and X_3 are simultaneously zero ($b_1=b_2=b_3=0$). The F-value provides a test of the null hypothesis that the slope coefficients are zero. If the computed F-value exceeds the critical F-value from the table at a given level of significance, we can reject the null hypothesis. As indicated in the table 9 (table10), the calculated F-value is 168.89. The table F-value is found to be 19.2 at 5% level of significance, which is far bellow the calculated value, and hence the null hypothesis is rejected. This suggests the overall applicability of the model.

A deeper look at the R^2value reveals that the existing model explains more than 99% of the dividend payment pattern of the private banking sector in Ethiopia since it assumes 0.9961.

4.4.2. Other Determinant Factors of Dividend

In this subsection, some determinant factors of dividend payment of the banks under study have been discussed based on the interviews conducted and by analyzing documents like proclamations, regulations and directives.

4.4.2.1. Ownership Structure and Agency Problem

The General Assembly is the final decision maker on dividend in the banks. All the share holders can participate in the assembly with no limitation on the amount of shares owned by each share holder. The decision is then passed through voting. The voting right of each share holder is dependent on the number of share holdings. This leads to the conclusion that ownership structure has its own influence on the dividend decision. Major shareholders can influence the decision over dividend of banks. Such practice of the banks is consistent with the literatures.

Most of the members of the board of directors of the banks are share holders, so that, the board takes in to account the agency problem in preparing the proposal that may prevail and reduce free cash flows that other wise might be spent on some unprofitable projects by management, in making decisions on dividend. This leads to the conclusion that ownership structure and agency problems get due consideration on the decision of the dividend payment.

4.4.2.2. Liquidity, Investment opportunities and Capital structure Concerns

The Board of Directors develops the proposal taking in to account the liquidity position of the bank. Even though there is no written or specified liquidity ratio by the banks other than the one stipulated by National Bank of Ethiopia, directive No.SBB/44/08, the liquidity status gets consideration on the decision of the proportion of cash dividend and on the number of shares each share holder is allowed to as dividend. Capital raising decision is the result of the liquidity concern of the banks in addition to other factors. However, in the empirical analysis above it is evidenced that liquidity position has no significant linear relationship with dividend for the reasons discussed in the empirical analysis.

Whenever there are investments to be undertaken by banks like construction of building and investments in other companies, the board incorporates it in the decision of the number of shares to be issued for the existing share holders and new ones if the existing ones are not interested to have their dividend in the form of new shares.

It is also found that the banks have no written target capital structure on which the amount of dividend is based other than the one stipulated by NBE, capital adequacy ratio Directive No.SSB/24/99. However, the amount of total liabilities and total assets are thoroughly analyzed at the end of each fiscal year before decision on dividend is made.

4.4.2.3. Long-term Debt and Dividend of Banks

In the literatures, it is assessed that if a firm has incurred long term debt, periodical payment of the principal and interest will be mandatory. As a result, some portion of the profit may be assigned to settle the debt, and has influence on the amount of dividend to be paid. In the case of private banks of Ethiopia, they incur no long term-liability. It is the banking industry itself issuing long-term liabilities to other sectors of the economy. The issuance of debt is currently unusual; the banking industry has no long-term debt by which the dividend payment is to be influenced.

4.4.2.4. Dividend of the Banks and Tax Considerations

As discussed in the previous section, once the amount of dividend and the number of shares to be issued in the form of dividend is decided by the General Assembly, it is the decision of the share holders to take in the form of cash or stock dividend. The usual practice of the banks is that the share holders prefer to take the stock dividend even though they need to get cash for their own purpose. The basic reason is that, whenever cash dividend is paid, the bank is required to withhold 10% dividend income tax as per income tax proclamation No. 286/2002, article 34. But there is no tax paid by the share holders on stock dividends. Directive No.17/1996 issued by Ministry of Revenue clearly lists business activities, in which share companies engaged, required to collect tax on dividend distributed in the form of shares Dividends used to increase the capital of share companies engaged on activities other than the listed ones are exempted from tax as per the directive. On the other hand, an investor interested to sell shares of his own can negotiate with a party willing to buy

the shares and can apply to the bank to transfer the ownership title to the buyer. In this case, if the shares are sold above the par value, the above mentioned proclamation requires the seller to pay 30% as per proc No.286/2002 capital gain tax over the excess amount. Due to the absence of transparency on the price of the shares being transferred, the seller discloses to the bank as the shares are sold at par value. And hence, share holders prefer stock dividend and transfer it to the third party and escape from paying capital gain tax and dividend income tax though the market is not liquid and encouraging to do so. This clearly indicates that the tax structure of the country affects the form of dividend payment of the banks.

4.4.2.5. Variability of Earnings and Dividend of the Banks

In situation where there is well developed capital market, the price of a stock is highly dependent on the amount of dividend of the stock. As a result, firms prefer stable dividend payments because it is evidenced that firms with stable dividend commands higher price. And hence, firms try to stabilize the dividend payment across periods, even though there is a variation in earnings. But in our case, the variability of earnings has no influence on the dividend payment decision. Banks don't try to stabilize their dividend payment. It varies with the direction of the variation in earnings. This really emanates from the absence of stock market in the country in which the shares of the banks can be traded publicly.

4.4.2.6. Legal Restrictions over Dividend payment of banks

The total after tax net profit of the banks is not ready for distribution to share holders of the banks. There are some restrictions over it from the government, National Bank of Ethiopia and from the banks themselves.

Legal Reserve Requirement-The government issued Licensing and supervisions of Banking Business No. 84/1994. In this proclamation, it is clearly indicated that every bank at the end of each financial year, transfer to its legal reserve account, maintained at the NBE, not less than 25% of its net profit. When the legal reserve account equals the capital of the bank, the amount to be retained can be reduced to10 %(Directive No. SBB/4/95) of the after tax net profit. The newly issued Banking Business Proclamation No. 592/2008 also repeats the same percentage legal reserve requirement.

Capital Impairment-Proclamation No. 592/2008 article 18, sub article 4 clearly indicates that no banks at any time declare or pay share holders any dividend until all impairments of its capital have been removed. So that, these banks are restricted from paying dividends if there is any impairment in capital.

Other Reserve-Banks can maintain different accounts at the national bank of Ethiopia. National bank of Ethiopia requires banks to transfer some portion of their profit as a reserve for any loss that may result from fraud or misconduct of management, though the national bank still yet not issued a specified directive on the percentage of this reserve. Most of the banks have a special /general reserve account at the national bank for this purpose. A certain portion of the after tax net profit of the

banks is transferred to this account. The amount and the percentage of this reserve differ across the banks and across periods.

Capital Adequacy Ratio- Directive No. SBB/24/99 issued by the national bank requires banks to maintain a minimum paid up capital levels not less than 8% of risk weighted assets. As a result, there may be a situation where the banks may be forced to transfer some portion of their profit to paid-up capital before decision to pay dividend is made. As per the responses of the officials, the actual capital ratio usually ranges around 15%, and hence this ratio is not as such a problem for the dividend decision of the banks.

Chapter Five

Summary, Conclusion and Recommendation

5.1. Summary and Conclusion

This paper has examined the dividend payment practice of private banks in Ethiopia. The paper has that the private banks under study have no written policy concerning their dividend payment except the one indicated in the articles of association in which it is indicated that the decision on dividend is to be made at the end of each financial year by the General Assembly. The paper has tried to analyze and made comparisons on the dividend payment trend of the six private banks under study for the period from 1999/00 to 2007/08. It is examined that AIB paid the maximum i.e. 69.45% of its earnings recorded in the form of dividend during the nine years, where as NIB paid the lowest percentage of its earnings (48.18%) during the same period. On average, the banks have paid 58.5% of their earnings as dividend during the period covered. Trends in average dividend per share were roughly parallel to that of the average earnings per share during the period.

Multiple Linear Regression Model was used to see the degree of association between some selected determinants factors that affects dividend payment of banks. Cross-sectional data of the six banks were extracted and used to see the extent of association.

The result showed that earnings as measured by the after tax earnings per share of the banks have significant positive association with dividend per share of the banks.

This positive association is consistent with the hypothesis developed in chapter one.

The regression result also showed that there is a positive significant association between dividend per share and financial leverage as measured by the ratio of total liability to total stock holders equity of the banks. This hypothesis contradicts with the hypothesis that debt to equity ratio has negative association with dividend. Most of the shareholders prefer stock dividend, and hence the stockholders equity of the banks increase, so that the ratio of total liability to equity decreases.

In the regression result, it is evidenced that the liquidity of the banks has no significant linear relationship with the dividend. The reason is that, most of the share holders prefer to take stock dividend to cash dividend, so that, it has no influence on the liquidity of the banks.

Other determinant factors like legal restrictions, tax considerations, ownership structure, and investment opportunities are also found to be essential determinants in addition to the earnings.

5.2. Recommendations

Based on the findings and conclusions of the paper, the following suggestions and recommendations are forwarded to the shareholders, banks and the government:

1. The decision on the dividend of the banks is made by the General Assembly at the end of each financial year as per their articles of association, and they have no written policy on dividend. The banks should develop such a policy by which they are to be guided while making decisions on dividend.
2. The tax structure of the country is found to be an important determinant factor for the dividend decision of the banks. The treatment of dividend tax (exemption of reinvested dividend) creates problem on the dividend decision of the banks. Government should develop a clear regulation or directive on this area considering the absence of stock market in the country, so that, proper decision on dividend can be made by the banks and shareholders.
3. Periodical valuation of shares should be done by banks, as a result share holders can be required to pay capital gain tax when they transfer shares, so that the influence of the transfer of share at par value on the dividend decision can be removed.
4. Government should facilitate the establishment and operation of stock market in the country, so that shares can be traded freely in the market. This will help share companies, including banks, not to be dependent on internally generated funds. They can make proper decision on dividend, and sell new shares in the market whenever need arises.