THE CENTRAL BANK OF KENYA'S DECISION ON DIVIDEND PAYOUT FOR BANKS: USING CASE OF LISTED BANKS AT NAIROBI SECURITIES EXCHANGE

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ABSTRACT

Dividend decisions and dividend payout has been a pertinent subject in modern financial management and in corporate finance. The subject is to determine a tradeoff between retained earnings and dividend payout being careful of kind of a Finance Manager's approach to decision making. The purpose of this paper was to critique the Central Bank of Kenya's new regulatory measures on dividend payouts by Kenyan banks in the midst of the COVID-19 pandemic using listed banks in Nairobi Securities Exchange. This was guided by the relevant and irrelevant dividend theories. Explanation research design was used with 12 students' sampled papers that represented 60% of the listed banks. Desk top survey was used with narrative and thematic analysis. The findings showed a mixed support for dividend payout with 4 key major themes: firstly, loan losses; secondly, clientele effect; thirdly, dividend irrelevance theory; and fourthly, dividend payout policy. The recommendation was for the Central Bank of Kenya should have examined banks' overall dividend payout on a case-by-case basis before stating a "blanket" statement. The contribution of this article is to integrate theory and practice both to bank's regulator, financial sector and to academic fronts.

Key Words: *Dividend theory, Dividend Policy, Financial Manageent, Central Bank of Kenya, Daystar University*

INTRODUCTION

Dividend per share is the yield that a company pays for the ordinary shares that are held by the shareholders. The dividend is calculated by dividing the total dividends paid out by the company, including interim dividends, over a period of time, by the number of outstanding ordinary shares issued (Miller and Modigliani, 1961). Actually, dividend is the part of profit or reserves that is distributed to shareholders. Dividend decisions are taken by the finance manager and approved by company directors. Dividend payout and policy remains one of the most controversial and unresolved issues in corporate finance. The management is in dilemma on how to pay a large or small percentage of their earnings as dividends or even just retain the earnings. The reason is that the management must satisfy the needs of the shareholders. According to Maclaney (2016), the dividend payout ratio is the amount of dividends paid to shareholders relative to the amount of total net income of a company. The amount that is not paid out in dividends to shareholders but is held by the company for growth is known as retained earnings. Key factors that determine how much dividend payout and the form to distribute them are as follows:

1. The size of the business
2. The stability of the firm
3. The dividend policy adopted by the management
4. The frequency of dividend payments

The Central Bank of Kenya (CBK) sent out a circular dated August 14, 2020, to all banks. The circular citing the critical role played by banks during the Corona Virus (COVID-19) pandemic by ensuring maintenance of banking operations, provision of credit and availing relief to borrowers by way of restructuring loans. In view of this, the Central Bank gave a circular that highlighted a consequence of commercial banks and mortgage finance companies that required further interrogation and evaluation regarding ways to address the impact in the immediate term (Central Bank of Kenya, 2020). The Circular further enumerated that in order to remain resilient banks would need to pay particular attention to bank balance sheets through additional capital and adequate liquidity. Subsequently, it was noted that those that would take precautionary measures would be resilient enough to better support post-pandemic economic recovery (Central Bank of Kenya, 2020). This is because, the Central Bank mandates banks' supervision on whether or not the capital levels arrived at by each bank is feasible. Banks are required to assess and maintain on a regular basis capital that is considered adequate to cover risks to which they are/might be exposed. The determination was made upon endorsement by the Central Bank of a bank board's decision to pay out dividends (Cytonn, 2020). Minimum capital requirement was considered imperative for banks as they needed to maintain limits that can meet credit, market, and operational risks (Farid, 2010). That notwithstanding, CBK reported that the banking sector experienced a drop in pre-tax profit for the year ended 2020 to Kshs.112.9 billion compared to Kshs.159.1 billion the previous year – marking an 8-year low (Mwaniki, 2021).

Further, this CBK's mandate on bank's supervision consists of ensuring financial stability by the maintenance of a functional banking system. Ensuring that commercial banks and mortgage companies implement internal procedures and systems to maintain adequate capital resources is essential to forestall economic shocks in the future. Notably, the banks went ahead to declare dividends that would be sustainable such as Kenya Commercial Bank declaring Kshs.1 dividend per share in contrast with Kshs.3.5 the previous year.

Purpose

The purpose of this paper was to critique the Central Bank of Kenya's [CBK] new regulatory measures on dividend payouts by Kenyan banks in the midst of the COVID-19 pandemic using listed banks in the Nairobi Securities Exchange.

LITERATURE REVIEW

Several theories have been put across, as academicians to view dividends decisions as either relevant or irrelevant in making financial decisions.

Irrelevant Theories

There are two Economists namely, Modigliani and Miller commonly abbreviated as "MM" who advanced for dividend irrelevance theory. This is based on assumptions such as: A world of no taxes whether personal/corporate, no transaction and bankrupt costs, absence of floatation costs on securities, perfect capital market in which investors are rational –no investor affects the market price of a security and perfect certainty by every investor as to future investments (Higgins, 1972; Brigham & Erhardt, 2015).

MM suggested that in a perfect world dividend policy of a company has no effect on the share price of company or the capital structure. If an investor gets dividends more than expected, then the surplus can be re-invested, while if too small then, the investor can sell a part of the shares and replicate the same cash flow. If the market is perfect, then investor does not care if the return is from dividends or capital gains. In the real world, the capital markets are imperfect and there are transaction costs, agency costs, asymmetric information and taxes are present. There is a rational behaviour where investors distinguish dividends and capital gains and their taxes are different. In Kenya there is no tax on capital gains. The higher the leverage the higher the cost of capital there is nothing like "no uncertainty". The theory shows there no difference between internal and external financing if floatation costs are there then that is false (Reinders, 1983; Miller & Modigliani, 1961; Luvembe, Njangiru, & Mungami, 2014).

The other theory is Tax Preference which was also developed by MM that used the same assumptions in an ideal world. The total market value of all assets issued by a firm is determined by the risk and return of the firm's real assets, not by the mix of issues securities which is referred to as capital structure (Modigliani & Miller, 1958). So, based on MM, neither the capital structure nor the dividend policy affects the value of the firm. They proposed that management should focus mostly where and in what firm's funds invest their funds rather than dividends' payout. Investors can control capital gains realization but cannot control dividend payments (. This theory was advanced later by other researchers who argued that investors prefer lower dividend payout companies for tax reasons. Dividends have a direct payment but capital gains allow investors to defer their taxes. Because of time value effects, tax paid immediately has a higher effective cost of capital than the same tax paid in the future. If shareholder dies, no capital gain tax is collected (Miller & Modigliani, 1961; Higgins, 1972).

Relevant Theory

The Bird in Hand theory is named after the popular adage a bird in hand worth two in the bush. This theory was put forth by Economist John Williams who believed that share price is determined by its intrinsic value and also the value of a share is determined only by the money that it brings. So, investors tend to favour the "bird in hand" - cash dividends rather that "two in the bush" - capital gains. Increasing dividend payments is then likely to increase the value of the firm. But increase in current dividends does not decrease the riskiness of the firm but actually works in the opposite direction (Kibet, 2015). Because increase in dividend payments are made make managers issue new shares in order to raise the needed capital. Therefore, dividend payment just transfers risk from the old shareholder to the new shareholder.

Another theory is the Gordon Dividend Growth Theory that Kibet (2015) states that,

> The underlying assumptions of Gordon's model is based on the idea of what is available today compared to what may be available in the future (Khan & Jain, 2008). It is based on the logic that the more distant the future is, the higher the uncertainty regarding capital gains and future dividends. Even though the capital gains in the future may provide a higher return than the current dividends, there is no guarantee that the investor will accumulate a higher return due to the high degree of uncertainty (Gordon, 1963). Since the length of the time and the level of risk are correlated, investors are unwilling to invest in companies where the time until the dividend payments are far away. An investor would therefore be willing to pay a higher price for firms that pay current dividends.

METHODOLOGY

This article was based on qualitative data where reading and understanding was expected from the students. Then the students were required to critique the material using explanation research design.

Population and Sample

The population was based on 35 students who were registered for the May 2021 semester. By the end of the two (2) weeks (15th July - 29th July, 2021), 30 articles were received on time, making the target population of this paper. The papers that complied with the expected rubric were selected forming the sample. Twelve (12) papers were chosen to give 40% for the input.

Analysis Method

The papers were intensely analyzed to help explain dividend payout using a practical element of the public listed companies in Kenya. The narrative analysis method was used because according to Butina (2015: citing Lieblich, Tuval-Mashiach, and Zilber, 1998), it is a "form of qualitative research in which the stories themselves become the raw data so as to explain more about the culture, historical experiences, identity, and lifestyle of the narrator”. Further, thematic analysis was used to reflect major themes in this article.

FINDINGS AND DISCUSSIONS

There are eight (8) banks listed in the Nairobi Securities Exchange that are required to publish their financial statements by the end of each year (NSE, 2021). According to Business Daily (31st March 2021), the eight listed banks paid a total of Kshs. 17.1 Billion based on the annual reports for the year ended December 2020. Students used 6 banks out of the 8 banks that represented 60% of the total banks listed in the Nairobi Securities Exchange (See Table 1).

Table 1: Banks Mostly Analysed in this Article

Name of the bank	Dividend per Share (Kshs.)		Dividend Amounts (Kshs.)	
	2020	2019	2020	2019
Diamond Trust Bank	2.70	2.60		
Kenya Commercial Bank	1.00	2.50	3.2 Billion	11Billion
Standard Chartered Bank	7.50		5.1 Billion	
NCBA	1.50		2.4 Billion	
Cooperative Bank	1.00		5.8 Billion	
Absa bank	1.10		5.9 Billion	

It was interesting to note that ABSA Bank declared a total of Kshs. 5.9 Billion as dividend amount, implying the highest paying out bank. But in terms of dividend per share the bank was among the least paid shareholders at Kshs.1.10. Further, the bank ended up suspending the dividend amount from being distributed to their shareholders. This was because the lender’s net profit plunged 43.8 per cent on costs linked to rising loan defaults as well as due to economic uncertainty in the wake of the Covid-19 pandemic (Arwa, 2020; Business Daily, 31st March 2021). Actually, Absa Group Limited forfeited Kshs. 1.2 Billion worth of dividends that were channeled towards Absa Kenya’s capital reserves. Therefore, this forfeiting did not produce a negative clientele effect, instead, the Kshs. 5.9 Billion worth of dividends propelled a high share price and an even higher volume of trade by investors shortly after the announcement. The share price reached a high of Kshs. 10.10 with a volume of 22.9 Million (Market Watch, 2021). As supported by Gul and Javed (2011), the trading volume and high prices could have been greatly influenced by the dividend announcement. For the year 2020 however, as advised by the CBK in an attempt to increase the capital reserves, Absa Bank did not pay out any dividends.

On the other hand, Cooperative declared 5.8 billion as dividend distribution while Standard Charted Bank declared Kshs. 5.1 Billion with Kshs. 7.50 per share. Cooperative Bank and Kenya Commercial Bank showed in their decision to maximize their shareholders' returns in form of dividends was pertinent to them for failure to which they would run the risk of disrepute in the investors' eyes. Diamond Trust Bank (DTB) was one of the banks whose dividend yields were affected during the regulations. Diamond Trust Bank Kenya announced a final dividend of Kshs. 2.70 per share and the total dividend payout by the Bank had increased by nearly 4% from the prior year (Shs 2.70 per share from Shs 2.60 per share last year). Nonetheless, the bank is currently ranked in the bottom 25% of yields that contribute about 4.8% whereas the market top 25% contributes around 7.7% of the dividend yield. While researching to find out why it is so lowly ranked, the DTB (2020) said that:

> There are a number of factors that can affect a share price beyond business performance, including supply and demand, peer performance, macro-economic conditions, speculation and political factors. In particular, we believe that the share price is currently impacted by the continuous exit from the Nairobi Securities Exchange market by foreign investors attributed to among other things uncertainty caused by the COVID-19 pandemic. It is also important to note that the downward trajectory of the share is not unique to DTB but is true for quite a number of listed companies, including listed banks.

The dividend policy for Equity Bank from the year it was listed on the Nairobi Securities Exchange in 2006 has been 30-50%. The last payout by Equity was in 2018. They froze the dividends payout due to net profit falling in 2019 and in 2020 the board decided to conserve cash due to unprecedented times caused by COVID 19 pandemic. In our view, the theory applied by Equity Bank is dividend irrelevance theory. In this theory, the value of the business is dependent on the income generated by its assets not how the income is split between dividends and retained earnings (Brigham & Erhadt, 2015).

The Critique

In Kenya since November 2016, Internal Capital Adequacy Assessment Process had been in place having been introduced by the Governor of Central Bank of Kenya. This is a process in which all banks are required to identify, measure, and monitor risks in order to utilize this basis for allocating funds (Cytonn, 2020). The Central Bank of Kenya (CBK) main goal was to achieve capital preservation in the economy and since the times of the COVID-19 pandemic, CBK speculated that this goal could be affected. Hence, the various themes that emerged from the findings are as shown in Table 2.

Table 2: Major Themes that Emerged

SRN	Reasons Debated for Dividends Decision	Trade Off Between Paying Dividends or withholding Dividends	
		Payout	Withholding
1	Clientele Effect		Yes because of Negative effects.
2	Loan Losses		Yes do not because of company's worth and reputation in question.
3	Dividend Irrelevance Theory	The value of the company is not measured by either.	
4	Dividend Payout Policy	Difficult to determine because of the orientation of the Finance Manager.	

The findings reflected in Table 2 show that there was a tradeoff between withholding and payment of dividends. Number one and two are discussed about the clientele effect and loan losses while number three and four points were not categorized to either payment or withholding dividends. The move to deter dividend payouts would have to be the most effective to counter the bad loans. Madura and McDaniel (1989) show that an increase in loan loss has the potential to convey to the market a negative strong signal that is the poor management of banks' loan portfolios. Thus, bad news can weaken investors' confidence so that the bank is more likely to face a financing problem.

Therefore, this CBK's decision to bar large dividend payouts in order to attain high levels of capital buffers can be supported by Modigliani and Miller (1961) theory of Dividend Irrelevance which argues that shareholders' wealth is affected by the income generated by the investment decisions a firm makes, not by how that income is distributed, hence their indifference to dividend payout. The dividend clientele effect according to Luvembe et al. (2014), comes into play when listed banks alter their dividend payment strategy drastically, causing an unfavorable reaction by investors; selling their shares which in turn reduces the share value of the listed companies. The clientele effect on the businesses would be that on one hand, the banks may lose shareholders who need current income especially during this difficult time of the pandemic. On the other hand, the shareholders who would be interested in withholding the dividends would view it as an advantage to them as they would save on taxes that they would have paid.

So, as more bank executives blame CBK's action for reducing the dividend payments, they also suggest that the factor can also be embedded in monitoring corporate governance issues (Business Daily, 2021). The criticism of this decision is that whereas there can be a legitimate concern over the level of dividends, the focus should be more on governance. If banks are not being governed well, dividend freeze cannot bring stability. The overload cash being locked up by the CBK would not make it right for all the banks to be treated the same whether big or small, yet it could be an individual's perception making the CBK make such a decision. As per the Business Daily (3rd March, 2021), many experts warned that the move by the CBK's decision would not be very productive since it only involved "holding a lot of idle cash and reducing the full functioning and performance of the banks". But a quick interjection showed that the intention of the CBK had a "pure intention of ensuring the banks come out of the uncertain COVID-19 period without much of a struggle".

According to Walter's theory of dividend decision, the choice of dividend policy that a firm chooses almost affects the value of the firm. This explains the importance of the relationship between a firm's internal rate of return and the cost of capital in determining the dividend policy that maximizes shareholders' wealth. This however explicates the assumption raised under Walter's theory in terms of investment opportunity of the firm that is financed by retained earnings. This is also supported by the M&M theory that argues for the firm's maximization rather than the dividend decisions. This automatically holds the dividend payout because after some time the firm's profit would increase (Raymond, 2018). But this would not be the case because it was the CBK holding the cash unlike the banks themselves! However, with theoretical and empirical research the above models cannot be fully used in dividend decisions since other factors should be considered to both protect the firm and shareholder's interests. For firms, it is important to have a balance of how much to pay the shareholder's while maintaining a balance with cash flows for investments (Lease et al., 2000, p.29).

Nevertheless, the fact that this has not worked well for other countries that implemented similar moves before made it doubtful in the Kenyan context. During the debate of having the CBK's decision to hold the dividends payout, one of the executives made a comment on the European and how they had handled the dividend by applying the same policy of holding the amount of the dividends. The "European banks regulator asked their banks to cut on their dividends during the pandemic" …but the banks had gone back to their normal operations (Business Daily, 2021). This was after their number of infections and death of COVID patients significantly declined much earlier than in Kenya and it would be unfair to compare because they have better facilities and infrastructure that enabled them to jump back faster into the economy after the pandemic compared to Kenya. Breale and Myers (2005), identified dividend policy as an unresolved issue in finance that lacks an adequate explanation for dividend behavior among different financial managers. A firm's decision to pay or not to pay is affected by different factors. The Central Bank should have looked at banks' overall dividend payout issues on a case-by-case basis because various factors that determine dividend payout as well as the banks' clientele needs that are different from bank to bank.

CONCLUSION

Firstly, as it is important to offer dividend payouts to the shareholders, a tradeoff between a firm's longevity in terms of investments and retained earnings need to be considered. The crucial factor that propelled the CBK's decision was the current COVID-19 pandemic which hit lots of companies inclusive of the banking sector. Secondly, it is banks decision to determine payment of dividends as well as to maintain a healthy cash flow as well as bank's longevity. Based on the findings the CBK should have been more lenient on banks and consider the specific bank ratios and whether they met the bank's requirements before revoking all dividend payments. In addition, the use of a one size fits all model while, determining the number of money banks should not have been applied for all.

Recommendation to CBK: The Central Bank should have examined banks' overall dividend payout on a case-by-case basis before stating a "blanket" statement.

Caveat Emptor:

This article was based on the lecturer's ideas to spur students in critic analysis based on previous announcements of the CBK.

Future Research:

From this analysis, there are gaps that we would like readers to do further engagement. For example, in terms of the methodology used- analysis of historical data (Survey). It could in future be enforced with other tools like interviews, questionnaire to enforce the information received from stakeholders such as the bank management and the shareholders.

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