

# **Bank Dividend Policy: Does the ESG Rating Matter?**

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*This paper examines the relationship of social responsibility and dividend policy of bank holding companies. Using the Sustainalytics ESG (Environmental, Social, Government) rating and its component scores as measures of social responsibility, the paper uses a variation of Rozeff's (1982) agency cost/transaction cost tradeoff model to evaluate bank dividend policy and the impact of social responsibility. The paper finds that bank holding companies paying higher dividends that force them into the external markets also have better corporate governance structures in place.*

*Keywords: banking, dividend policy, social responsibility, ESG ratings*

## **INTRODUCTION**

Previous studies, such as Dickens, Casey and Newman (2002) identify various bank dividend policy determinants. Dividend policy is important since the theoretical value of the firm can be viewed as the present value of all future dividend streams. However, dividend payment also conveys information to stakeholders that include current and potential investors, analysts, and other parties with an interest in the firm's survival (Barclay, Smith and Watts; 1995).

More recently studies such as Casey, Ellis and Casey (2019) find a link between corporate social responsibility and dividend policy. As suggested by Rozeff (1982) managers appear to adopt a dividend payment model that minimizes the sum of agency costs and transaction costs to the firm. Given that banks sometimes evoke negative reactions due to the politically charged environment it seems reasonable to believe that bank dividend policy may have some relationship to social responsibility. The purpose of this paper is to empirically investigate that linkage and answer the question of whether bank managers consider social responsibility factors when setting dividend policy.

The remainder of the paper is organized as follows. Section II contains a review of the literature and Section III provides a presentation of the data and methodology employed in this study. Section IV presents the results and Section V contains a presentation of our conclusions and directions for future research.

## **LITERATURE REVIEW**

The literature shows that corporate social responsibility is linked to firm performance and various discretionary managerial decisions. For example, Galbreath (2010) evaluates whether a link exists between

social responsibility and strategic orientation and finds support for that position. Other research, such as Hsu (2018), finds that firms that exhibit good stewardship tend to make better financial decisions and do a better job of allocating capital to positive net present value projects. Numerous other papers support a link between social responsibility and performance. These include Buallay (2019) and Feng, Wang and Kreuze (2017). A few researchers find a linkage between dividend payout and corporate social responsibility. Examples include Casey, Ellis, Casey (2019) and Samet and Jarbouï (2017).

One way to measure the components of social responsibility is by using ESG scores or ratings. ESG (environment, social and governance) ratings provide researchers with a metric that quantifies a firm's commitment to social responsibility. This score can also be split into its various components to identify specific social responsibility decisions that may have greater impact on the firm. Baulley (2019) and Casey, Casey and He (2018) both utilize ESG scores when evaluating the impact of social responsibility on the performance of European banks (Baulley) and dividend policy of public utilities (Casey et al.).

Several studies, such as Feng et al. (2017) and Nyeadi, Ibrahim and Sare (2018), find that industry differences exist. For this reason it is more appropriate to evaluate the impact of ESG ratings using a specific industry. In this paper we focus on the banking sector given continued negative press about the banking industry. In addition, several studies use variations of Rozeff's (1982) agency cost/transaction cost tradeoff model to evaluate bank dividend policy. These include Casey and Dickens (2000) and Dickens, Casey and Newman (2002).

Jensen and Meckling's (1976) seminal agency theory paper states that the separation of ownership and management that exists in publicly traded firms creates the potential for agency problems. Given that owners and managers often have different goals the firm must find ways to align these goals. Any costs incurred to align these goals are known as agency costs that include numerous oversight and internal control techniques designed to ensure management behavior is consistent with the primary goal of the owners, which is shareholder wealth maximization.

Dividend payment has also been shown to be an agency cost that helps align goals. When a firm pays dividends it depletes cash. This action forces the firm into the external capital markets to acquire necessary financial capital for operations and/or expansion. All external stakeholders, including underwriters, analysts, potential investors and other parties evaluate the firm's financial condition, recent managerial actions, corporate governance mechanisms, and other factors prior to providing external capital. This thorough external review uncovers any issues that will negatively impact the firm and future cash flows. Social responsibility issues, including corporate governance mechanisms and environmental actions, fall into this category. Dividend payment can be considered an agency cost since retaining dividends for internal financing would be an easier option for firms seeking expansion capital or firms needing capital for existing operations. Instead the firms opt to pay dividends and seek external capital to signal information to the market. For this reason we can use dividend payment and social responsibility metrics to determine whether a relationship does indeed exist. Specifically, do banks that are more socially responsible pay more or less in dividends?

Numerous researchers use an adaptation of Rozeff's (1982) model. These include Noronha, Shome, and Morgan (1996), Moh'd, Perry, and Rimbey (1995) and others. The model has also been adapted to evaluate the link between corporate governance and dividend payout. Puleo, Smith, and Casey (2009) find that regulated firms in the insurance industry have a lesser need to pay dividends and subject the firm to the scrutiny of the external capital markets. Regulation appears to replace the need to pay dividends and convey information to external stakeholders. Smith, Puleo, and Casey (2008) find that non-regulated firms with higher corporate governance quotients pay lower dividends. This finding suggests that the external scoring of a firm replaces the need for regulation. In their study, firms recognized externally as better corporate stewards can lower dividend payout since they have a lesser need to convey governance information via dividend payment and force firms to raise external capital.

Yahoo! finance recently added a series of sustainability metrics that provide scores for a firm's "environmental, social and governance issues" (ESG). The ESG data focuses on issues that are most likely to affect the firm and assesses the firm's "ability to mitigate ESG risks." The availability of this metric provides the data needed to evaluate the relationship between dividend policy and ESG factors. We use the

banking industry and evaluate the impact on dividend payout using an overall ESG score and then look at the individual components of ESG. The ESG factor is split into governance, environmental and social affects with numerical scores for each individual component. Yahoo! Also reports a controversy score that provides even more detailed information about the public perception of the firm. Casey, Casey and He (2018) note that today's investors are more interested in socially responsible investing and are willing to reward firms that possess the desired socially responsible characteristics and punish firms that do not possess these traits. This shift in investor expectations should be evident in the link between ESG ratings and dividend policy.

## DATA AND METHODOLOGY

For this paper we collected 2018 data from Yahoo! Finance for bank holding companies. The sample size includes 40 firms with sufficient data to run the models. We estimate the following version of Rozeff's (1982) model consistent with Casey, Ellis and Casey (2019) and Casey, Smith and Puleo (2010) who both use a similar model in the oil and gas industry.

$$DPO_j = \alpha + \sum B_i X_{ij} + \varepsilon \quad (1)$$

where:

DPO = dividend payout as reported by Yahoo! finance

Xij represents each independent variable I, for each firm j. These variables are:

- INSIDE = percentage of insider ownership,
- BETA = each firm's beta,
- DEBT = total debt/equity ratio,
- GROWTH = next year's percentage forecast growth rate in revenues,
- ESG = Sustainalytics total ESG rating,
- CONT= controversy rating assigned by Sustainalytics.

The ESG rating can be split into its three components of Environment rating (ENV), Social rating (SOC) and Governance rating (GOV). Each of these ESG ratings can fall between 1-100. The ratings are calculated using a proprietary balanced scorecard system. Percentile rankings are also reported for these individual components. Justification for the remaining included variables follows.

**CONT**, or the controversy rating computed by Sustainalytics, assumes a value between 1 and 5 and is assigned based on recent controversies involving the specific firm. A value of 5 indicates a serious controversy affecting the firm's stakeholders, the environment, or the firm's operations. Firms with higher controversy ratings will likely need to increase dividend payout and subject the firm to the scrutiny of the financial markets with greater frequency. However, an alternative justification would be for the firm to conserve cash with the expectation of incurring higher legal costs.

Justification for the other included control variables follows:

**Inside**, defined as the percentage of insider equity ownership, could have a positive or negative relationship to dividend yield. Depending on the overall faith in management, insider ownership may be a valuable indicator to other stakeholders about management's perceived value of the firm. On the other hand, if confidence in the management is low, the firm may need to pay a higher dividend and subject the firm to financial market scrutiny.

**Beta**, the firm's beta computed and reported by Yahoo! finance, serves as a measure of market risk. Investors with higher risk tolerances will likely prefer firms reinvest earnings instead of paying cash dividends. For this reason, Beta should be negatively related to dividend payout.

**Debt** represents the firm's use of leverage. We use the total debt to equity ratio provided by Yahoo!. As debt increases, firms may opt to retain funds for debt service in lieu of paying out cash dividends.

However, an opposing position suggests that firms paying higher dividends could be forced to incur more debt for capital budgeting and operations. Therefore, debt could have either a positive or a negative sign.

**Growth**, or next year's forecast revenue growth rate, serves as a proxy for the firm's immediate future cash needs. Higher growth rates suggest the firm should retain cash to support that growth. For this reason, we expect to see a negative relationship between growth rates and dividend payouts.

## RESULTS

The descriptive statistics for the variables included in this study are shown in Table 1. Note that many of the variables have a wide variation. For example, the dividend payout ratio ranges from 0.0 percent to 78.16 percent. Insider ownership shows a similar variation ranging from 0.0 percent to 77.8 percent while beta ranges between 0.44 and 1.87.

**TABLE 1  
DESCRIPTIVE STATISTICS BANK HOLDING COMPANIES**

Variable	Obs	Mean	Std. Dev.	Min	Max
DPO	40	30.1675	14.65487	0	78.16
Inside	40	6.511	15.96082	0	77.8
Beta	40	1.22225	0.338644	0.44	1.87
Debt	40	88.69117	3.282147	77.66601	94.47391
Growth	40	6.5725	6.170234	-4.2	35.1
Esg	40	55.95	8.886608	45	78
Env	40	51.225	19.17462	32	89
Soc	40	60.375	5.192141	50	70
Gov	40	55.775	8.138189	41	80
Cont	40	2.075	0.997111	0	5

The ESG rating ranges from 45 to 78 with a wider variation noted in Env ranging from 32 to 89. The variables Soc and Gov have a tighter range relative to Env. The controversy level (CONT) has a mean of 2.075 and ranges from 0 to 5.

In Table 2 we report the variable correlations. Note that none of the variables are highly correlated with the exception of high ESG correlations with each component. However, ESG is not included in the same model as each ESG component so these correlations are irrelevant.

**TABLE 2  
CORRELATION MATRIX**

	DPO	inside	beta	debt	growth	esg	env	soc	gov	cont
DPO	1									
Inside	0.0144	1								
Beta	-0.3636	0.1011	1							
Debt	-0.1761	-0.0163	-0.1943	1						
Growth	-0.2045	-0.0483	-0.0164	0.1042	1					
Esg	0.1434	-0.1515	-0.1415	0.2548	-0.2245	1				
Env	0.0995	0.0873	-0.0565	0.1665	-0.3208	0.9239	1			

<b>Soc</b>	0.0706	-0.3764	-0.1753	0.1756	0.1101	0.6589	0.4607	1		
<b>Gov</b>	0.2004	-0.3717	-0.2006	0.3539	-0.0902	0.8164	0.5731	0.5373	1	
<b>Cont</b>	-0.0329	0.3835	0.2083	-0.1241	-0.2101	0.4113	0.612	-0.065	0.0938	1

Table 3 contains a presentation of the OLS regression results. The models range in significance from 0.050 to 0.132. The adjusted R2s of the models range from 0.120 to 0.152 which indicates the models explain between 12 percent and 15 percent of the variation in dividend payout ratio. We will confine the discussion to the models that were significant at the 0.10 level or better (Models 1, 2, 3 & 6). Note that beta and debt are both significant in all models.

**TABLE 3**  
**OLS REGRESSION RESULTS FOR DIVIDEND PAYOUT FOR 40 BANK HOLDING COMPANIES OR BANKS**

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Inside	0.040 0.290	0.058 0.420	0.201 1.160	0.129 0.790	0.214 1.200	0.053 0.360
Beta	-18.054 *** -2.750	-17.606 ** -2.660	-16.398 ** -2.470	-16.102 ** -2.340	-15.812 ** -2.300	-17.788 ** -2.630
Debt	-1.059 -1.560	-1.214 * -1.720	-1.525 ** -2.100	-1.381 * -1.870	-1.598 ** -2.100	-1.072 -1.550
Growth	-0.438 -1.240	-0.357 -0.970	-0.466	-0.373 -1.000	-0.437 -1.070	-0.455 -1.240
Esg		0.216 0.810		0.375 1.140		
Env			-0.149 -0.850		-0.084 -0.350	
Soc			0.127 0.220		0.036 0.060	
Gov			0.715 * 1.740		0.701 * 1.680	
Cont				-2.561 -0.850	-1.432 -0.400	-0.582 -0.230
_cons	148.819 ** 2.400	149.233 ** 2.390	147.346 ** 2.160	158.298 ** 2.490	158.735 2.120	150.810 ** 2.380
F	2.640	2.220	2.000	1.960	1.730	2.070
Prob>F	0.050	0.075	0.086	0.101	0.132	0.094
R <sup>2</sup>	0.232	0.246	0.305	0.262	0.308	0.233
Adj_R <sup>2</sup>	0.144	0.135	0.152	0.128	0.130	0.120

\*significant at the .10 level

\*\*significant at the .05 level

\*\*\*significant at the .01 level

Model 3 includes the distinct components of ESG. Note that the governance variable (gov) is positive and significant at the 0.10 level or better. It appears that firms with higher governance scores also pay more dividends. None of the remaining ESG variables mattered in any of the models. Controversy (Cont) was not significant in any model.

## CONCLUSIONS

The regressions help explain part of the variation in bank holding company dividend policy. Consistent with previous studies using Rozeff's (1982) model we find that both growth rates and debt levels are important in establishing dividend payout. Bank holding companies with higher levels of risk (beta) retain more cash instead of paying dividends. In addition, bank holding companies that make greater use of leverage also retain more cash and payout less in dividends.

The ESG variables largely do not matter to bank holding companies when setting dividend policy. The one exception is governance (gov) which is significant and positive. Banks that pay higher dividends also receive higher corporate governance structures. This metric is computed by evaluating the firm's corporate governance structures used to protect stakeholders. Business ethics issues and board accountability are examples of some of the inputs evaluated by Sustainalytics when computing this score. It is not surprising that bank holding companies paying higher dividends that force them into the external markets also have better corporate governance structures in place.

ESG research continues to evolve and is becoming more important as firms focus more and more on stakeholder issues. Additional work on banks and firms in other industries will shed more light on how ESG factors affect managerial decisions.

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