Insurance company dividend policy decisions

Evidence on the role of corporate governance and regulation

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Abstract

Purpose – The purpose of this paper is to explore the relationship between good corporate governance and dividend payment in the regulated insurance industry.

Design/methodology/approach – A modification of Rozeff's transaction cost/agency cost trade-off model was estimated on a sample of 55 firms in the insurance industry. Data cover a five-year period ending in 2006.

Findings – Consistent with an agency view of dividends functioning to reduce the need for firm monitoring, it was found that there is no relationship between good corporate governance and dividend policy in a regulated industry. In other words, regulation appears to supplant the need for most corporate governance mechanisms and dividend distribution to provide information.

Research limitations/implications – One data point used in this study, the corporate governance quotient (CGQ), is a relatively new metric created in 2001. Therefore limited use of this variable has appeared in previous research. Additional work is needed to fully evaluate the effectiveness of CGQ as a true measure of corporate governance.

Practical implications – Regulated firms in the insurance industry do not need to be subjected to the external monitoring forced by high dividend payments. Regulators perform that function instead.

Originality/value – This study is the first to evaluate the impact of good corporate governance on regulated firms' dividend policy.

Keywords Insurance companies, Dividends, Corporate governance, Business policy, Regulation

Paper type Research paper

Introduction

Agency conflicts resulting from the separation of ownership and control between shareholders and managers can influence expected cash flows to investors and are therefore important to shareholder wealth (Jensen and Meckling, 1976, Fama, 1980, Fama and Jensen, 1983). The payment of dividends is one mechanism often used to mediate or reduce agency costs (Jensen and Meckling, 1976; Crutchley and Hansen, 1989). Optimal dividend payout in which dividend policy can be at least partially explained by an agency cost-transaction cost trade-off model is provided by Rozeff (1982). He suggests that the payment of dividends forces the firm more frequently to the external capital markets and the subsequent external scrutiny serves as a bonding or monitoring function, thus reducing agency costs. However, the firm incurs transactions costs in going to the external markets. The optimal dividend policy therefore would minimize the sum of agency costs and transaction costs. Easterbrook's (1984) position that the payment of dividends and the subsequent raising of capital

play a role in controlling agency costs by facilitating monitoring of firm activity and performance by the primary capital market supports Rozeff's findings.

Good corporate governance may also lower the costs of agency conflicts and influence dividend policy by reducing shareholders' monitoring and auditing costs. In this framework, corporate governance serves as a bonding mechanism. Rozeff (1982) links two corporate governance mechanisms to dividend policy, percentage of stock held by insiders (insider ownership) and dispersion of ownership among outside stockholders (ownership concentration). He provides evidence that higher dividend payout ratios are found among firms with lower levels of insider ownership and/or higher levels of ownership concentration. Rozeff's observations are supported by Dempsey and Laber (1992) and Crutchley and Hansen (1989).

Smith *et al.* (2008) extend Rozeff's (1982) model and examine the relationship between a firm's dividend policy and corporate governance. Overall, their findings indicate that firms with stronger corporate governance pay lower dividends. However, their study excluded highly regulated firms, like insurance organizations, that already have an external monitoring source. The purpose of this study is to examine the relationship between corporate governance and dividend policy in the highly regulated insurance industry.

Literature review

Rozeff (1982) argues that the agency cost-transaction cost trade-off model can partially explain dividend policy. The payment of dividends forces the firm more frequently to the external capital markets where the firm must undergo the scrutiny of the investment banking and regulatory communities to raise new capital. This process thus eliminates much of the need for monitoring by the existing shareholders. Dividend payments serve as a bonding or monitoring function and thus reduce the agency costs of equity in this framework. Transactions costs are incurred, however, in going to the external markets. According to Rozeff (1982) the optimal dividend policy is therefore one that minimizes the sum of these agency costs and transaction costs.

Several researchers have extended Rozeff's (1982) original study by adapting his model to different situations. Noronha *et al.* (1996) adapted the original model to evaluate the connection between dividend policy and capital structure. Their study develops an agency cost framework for the simultaneous determination of dividend and capital structure policy consistent with Easterbrook's (1984) position. Other studies including Moh'd *et al.* (1995) and Dempsey and Laber (1992) clearly show the model holds up well over time in addition to across a number of industry segments. Perhaps more relevant to this paper is the work of Casey *et al.* (2007) that explores the dividend payout policy of firms in the insurance industry using a modification of Rozeff's (1982) model. Their study finds support in the insurance industry for the agency cost-transaction cost trade-off model.

Several researchers have examined the link between corporate governance and dividend policy. One study by La Porta *et al.* (2000, 2002) uses measures of shareholder protection in a firm's country as a proxy for agency problems to examine the dividend policy of firms from 33 countries. Their study finds that average dividend payouts are higher in countries with greater levels of shareholder protection suggesting that more powerful shareholders (i.e. stronger corporate governance mechanisms) have greater ability to extract dividends from managers.

Farinha (2003) finds a positive and significant relationship between corporate governance and dividend policy in the UK. This study hypothesizes that firms with

stronger internal corporate governance mechanisms also "use dividend payouts more intensely". Farinha concludes that corporate governance and dividend payout are better viewed as complementary monitoring mechanisms instead of substitutes. Both La Porta *et al.* (2000, 2002) and Farinha (2003) would support a positive relationship between corporate governance in regulated firms and dividend policy.

Conversely, Smith *et al.* (2008) examine the relationship between corporate governance and dividend policy by extending a modified version of Rozeff's (1982) model to include proxies for good corporate governance. Their findings indicate that firms with stronger corporate governance pay lower dividends. However, their study excluded highly regulated firms, like insurance organizations, that already have an external monitoring source. Highly regulated firms already have an external monitoring source that should improve corporate governance. Aggarwal and Williamson (2006) find statistically significantly higher governance scores for these sectors (lower for banks) relative to other industries.

In this study, we extend previous research by providing additional evidence of the relationship between dividend payout and corporate governance of US-based firms in the heavily regulated insurance industry.

Methodology

Expanding on Rozeff (1982), we employ a multivariate analysis with Dividend Yield (DY) as the dependent variable, and independent variables found to be significant in prior research. Utilizing prior testing methodology allows us to see if the new Corporate Governance Quotient (CGQ) plays a role as a substitution mechanism for dividend payouts. The model is:

$$DY = BETA + REV5 = IBES5 + INSIDE + CMSHARE + IndCGQ + PropCas + C$$

(1)

DY is the year end total dividends divided by the year end stock market price as reported by Compustat. Previous research (e.g. Smith *et al.*, 2008) has shown that the specification of multivariate models is much better when DY is used relative to dividend payout.

IndCGQ is the Industry CGQ as given by Institutional Shareholder Services (ISS) available in Yahoo Finance. Aggarwal and Williamson (2006) find statistically significant cross-sectional differences in the Industry CGQ for firms in the same industry. IndCGQ tests how the corporate governance of firms, relative to other firms in their own industry, might impact this substitution effect of governance for dividends. Studies suggest the ISS standards of governance are more rigorous than previous measures (e.g. Investor Responsibilities Research Center) and as such might impact inferences, especially for weaker governance firms (Aggarwal and Williamson, 2006). Smith *et al.* (2008) showed that for non-highly regulated firms, Industry CGQ was statistically related to lower DYs. It is believed that higher corporate governance that already exists in a regulated industry could serve as a bonding mechanism, allowing firms to substitute regulated governance in lieu of a dividend payout. Therefore, firms in regulated industries such as insurance should not see the same inverse relationship between CGQ and dividend payout.

All of the remaining variables are collected from Compustat. BETA represents the relationship between the stock price movement and a market index. In this case, however, it also serves as a proxy for size. Larger, more mature firms, which would

tend to have lower betas, also are likely to have stronger corporate governance structures. The expected sign for the coefficient estimate is positive, indicating that lower beta firms (larger firms) would not need to pay dividends to satisfy shareholder monitoring requirements.

REV5 is a five-year total percentage, change in revenue growth found by taking the end-of-year sales in year five and subtracting it from the time period zero sales, then dividing by the year zero sales. Higher revenue growth is correlated with higher cash flow needs by a business. This would typically lead to lower free cash flow and therefore less possibility that these free cash flows would then be used by management to distribute dividends. We would then expect the coefficient estimate to be negative.

IBES5 is an estimate of the future five-year median growth rate in earnings per share based on IBES or analysts estimates. Higher future growth in earnings per share would tax a business to provide the cash flow to support it, thereby limiting excess free cash flow. Cremers and Nair (2005) also noted that firms with stronger shareholder rights also tend to earn higher accounting profitability. We would therefore expect the coefficient estimate associated with this variable to be negative.

INSIDE is the percentage of the total outstanding shares owned by top management. Previous research has shown that higher insider ownership binds managers to the future results financially, thereby limiting the perquisites and poor management of excess cash flow. This would lead to an expected negative sign on the coefficient estimate for this variable.

CSLN is the natural logarithm of the total common shareholders as found in Compustat. We took the natural log to adjust for the non-linearity of the original variable values. Rozeff (1982) showed that a larger number of shareholders have a greater difficulty in monitoring management. The expectation is that this variable will have a positive sign on the coefficient estimate.

PropCas is a dummy variable representing property-casualty insurers. Property-casualty insurers are more heavily regulated and are subject to price regulations than non-property-casualty insurers. Regulators monitor the actions of property-casualty insurer managers more closely since the insurance premiums are subject to regulatory approval. This additional regulatory activity effectively reduces the agency costs of property-casualty insurers borne by shareholders. The expected sign for PropCas is negative.

Data
The data source for this study is Compustat. We identified insurance companies by using Standard Industrial Classification codes. Firms were removed from the data set due to incomplete data or non-dividend paying stocks. The sample included 55 insurance organizations with observations for the five-year period 2002-2006. We are interested in this time period because it allows us to look at the five-year averages used in the original Rozeff (1982) paper, as well as coinciding with the initiation of the CGQ measure in 2001. The total firm-year observations for this study of the insurance industry is 241.

Results
Comparing the summary statistics of insurance firms to previous industry relative research (Smith *et al.*, 2008), we find the insurance organizations on average have a lower IndCGQ score and higher inside ownership, which might imply that the bonding mechanism of higher management participation in stock price moves could be a factor

in keeping the IndCGQ down. Even though the insurance organizations have grown more quickly than the other firms over the last five years, analysts expect them do more poorly in the future. Table I also shows that the overall DY of the insurance organizations is lower than in previous research, but there is a wider dispersion of stock among market participants.

The correlation comparison in Table II shows a similar pattern between the two studies of weak correlations to the IndCGQ variable, with the exception of insider ownership and the common stock variables. The higher insider ownership has the strongest correlation indicating that more ownership is related to lower IndCGQ scores. This would be more likely for entrenched management. The fact that BETA is not closely related suggests it is not a big firm phenomenon.

	Previous	Current
CGQIND	85.96	73.49
BETA	0.99	0.84
REV5	56.31	73.47
DY	1.76	1.41
IBES5AVG	12.09	10.91
INSIDE	4.47	6.90
CSLN	3.02	4.22

Notes: These are the summary statistics for the regression model variables. CGQInd is the variable associated with the corporate governance score for each firm, relative to others in the same industry according to ISS. All the remaining variables are as reported by Compustat. BETA is the relationship between the stock price movement and its index. REV5 is the total growth in revenue per share for the previous five years. DY is the dividend for the fiscal year end divided by the end of year stock price. IBES5AVG is the five year forward looking average according the analysts. INSIDE is the inside ownership as a percentage of the shares outstanding. CSLN is the natural log of the number of common shareholders at the end of each company fiscal year end

Table I.
Summary statistics

	Previous	Current
	CGQ Ind	CGQ Ind
Variable		
CGQIND	1	1
BETA	−0.00795	0.08050
REV5	−0.10855	−0.23236
IBES5AVG	−0.04142	0.095811
INSIDE	−0.26472	−0.55882
CSLN	0.149115	0.348747

Notes: This table provides the correlations between all variables included in the model for the full data set. For brevity, only the correlations for the CGQInd are compared. CGQInd is the variable associated with the corporate governance score for each firm, relative to others in the Industry according to ISS. All the remaining variables are as reported by Compustat. BETA is the relationship between the stock price movement and its index. REV5 is the total growth in revenue per share for the previous five years. IBES5AVG is the five year forward looking average according the analysts. INSIDE is the inside ownership as a percentage of the shares outstanding. CSLN is the natural log of the number of common shareholders at the end of each company fiscal year end

Table II.
Correlation matrix

When comparing results of the original study utilizing CGQ in the Rozeff model (Smith *et al.*, 2008), we find that the main variable of interest, IndCGQ is not a significant variable in the model. The binary PropCas variable improves the overall model and is significant at the 0.01 level albeit with the wrong sign. Expectations were that PropCas would be inversely related to dividend payment instead of positively related as this study finds.

Several other variables were also significant, even though the sample size is not quite one-fourth the size of the previous study. Consistent with Smith *et al.* (2008) IBES5, REV5 and CSLN are highly significant (see Table III). Higher IBES5 and REV5 suggests that higher expected and current growth rates leads to lower DYs and a higher dispersion of ownership leads to higher DYs. The sign on INSIDE is positive in this study, while in a previous study was negative. While a higher level of management participation in stock prices lead to higher DYs in this study, the opposite was true before. This finding could be related to controlling for the larger dividend payers through the inclusion of the PropCas variable. It should also be noted that INSIDE was only weakly significant with a *p*-value of 0.09.

Perhaps, the single most important result is that for highly regulated firms, the industry CGQ variable is insignificant and therefore cannot substitute as a bonding mechanism in lieu of a DY.

Conclusions

The purpose of this study was to investigate the impact of good corporate governance as measured by CGQ on dividend policy in a regulated industry. Our results are

	Previous		Current	
Variable	Coefficient	Prob.	Coefficient	Prob.
CGQIND	−0.012	0.008***	−0.00281	0.4309
BETA	−0.202	0.021**	−0.23831	0.211
REV5	−0.002	0.020**	−0.00291	0.0084***
IBES5AVG	−0.129	0.000***	−0.19893	0.000***
INSIDE	−0.017	0.000***	0.012923	0.0908*
CSLN	0.104	0.000***	0.088912	0.014**
C	4.059	0.000***	3.710	0.000***
PropCas	N/A		0.494042	0.0022***
R^2	21.37%		27.31%	
Adjusted R^2	20.78%		25.12%	
N	932		241	
*	10%			
**	5%			
***	1%			

Notes: These are the results from a multivariate regression with DY as the dependent variable. CGQInd is the variable associated with the corporate governance score for each firm, relative to others in the industry according to ISS. All the remaining variables are as reported by Compustat. BETA is the relationship between the stock price movement and its index. REV5 is the total growth in revenue per share for the previous five years. IBES5AVG is the five year forward looking average according the analysts. INSIDE is the inside ownership as a percentage of the shares outstanding. CSLN is the natural log of the number of common shareholders at the end of each company fiscal year end

Table III.
Dividend yield
regressions

inconsistent with the theory that strong corporate governance supplants the need to subject the firm to the external monitoring of capital markets forced due to dividend distributions. Regulated firms therefore appear to be able to rely on external monitors already in place as a result of the regulation and on dividend distribution. In fact, strong corporate governance appears to be unrelated to dividend payout in the insurance industry.

Previous research on non-regulated firms is conflicting in this regard. Farinha (2003) finds that strong corporate governance mechanisms are complements to dividend payout and subsequent external monitoring. However, Smith *et al.* (2008) finds the opposite is true. Firms with strong corporate governance can reduce dividend payout. In the current study the strong significant positive relationship of PropCas supports Farinha's complement theory. The more highly regulated property and casualty insurers do appear to pay out more in dividends. Further research is needed to fully determine the interlocked relationships among corporate governance mechanisms, regulation and dividend payouts.

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