

# Securitization: The Concept and Its Relevance to Indian Banks

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## INTRODUCTION

After liberalization, innovative financial techniques and new financial instruments in the financial market may facilitate better channelisation of domestic as well as foreign savings. As a result, the capital market and money market get wide and deep. In fact, the development of a debt market increases the efficiency of a capital market to greater extent. Therefore, along with the equity market, there is bound to be natural growth in the debt market also. Thus, it is obvious that a debt market should also have both primary and secondary market. That way asset securitization assumes a significant role and is one of the exemplary financial innovations. Asset securitization is an important *financial innovation* which stands out not only as important in itself, but also as the springhead of many innovative techniques in the debt market increases to achieve above objective.

Securitization is a process by which financial assets are pooled and the cash flows are used to guarantee and service a security. Virtually any kind of asset, which can generate a stream of cash flows, can be securitized. These securities are subsequently subscribed to and traded among the investors. These financial assets can be residential mortgages, auto loans, credit card receivables, leases, consumer loans, trade credits, corporate bonds etc. If the asset is a mortgage, the instruments are called mortgage-backed securities and the other instruments are known as non – mortgage asset backed securities.

According to John Henderson & Jonathon Scott, securitization is defined as the process which takes place when a lending institution's assets are removed in one way or the other from its balance sheet and are funded instead by the investors who purchase a negotiable financial instrument evidencing this indebtedness, without recourse to the original lender.

The securitization of debt originated as a response to the twin problems of liquidity crunch and concentration of risks faced by financial institutions. Asset securitization is a product of financial engineering which enables the structuring and selling of negotiable instrument in order to spread risk over a large group of investors, a risk which would normally have been taken by a lender or a consortium and thereby make funds available to borrowers which would otherwise not have been possible. This is the risk management aspect of banking which securitization deals with. Securitization can also be used as a tool for fund management. In case of financial institutions large funds are locked up in loans and advances given for development projects. The cash flows from these assets come over an extended period and in small quantum. By resorting to securitization, financial institutions can convert these illiquid assets into cash and use these funds for making further investments thus increasing the profitability of the organization as a whole.

## ORIGINATION OF SECURITIZATION

Formally, Securitization, originated in the US during the 1970s when the Government National Mortgage Association (GNMA) started the trading in securities backed by pools of mortgage loans. It was followed by Federal National Mortgage Association and similar organizations. It is in March 1985 that non-mortgage collaterals started getting securitized in the USA. The First offering of \$192 mn of leased backed notes for Sperry Lease Finance Corporation was underwritten by First Boston. Since then the concept has grown enormously, today the total Asset backed securities in USA is estimated at over \$ 1000 bn. In UK, the Bank of England has issued various guidelines and helped in developing the product. Securitized debt instrument is now popular in Italy, Spain, Austria, France, Canada, Japan and many other countries and most of the countries have passed legislation to facilitate the process of securitization and this is enabling the banks to divert their debt to the capital market. According to estimates, 35 per cent of all securitization deals between 1992 and 1998 related to hire purchase receivables of trucks and the rest towards other auto/transport segment receivables.

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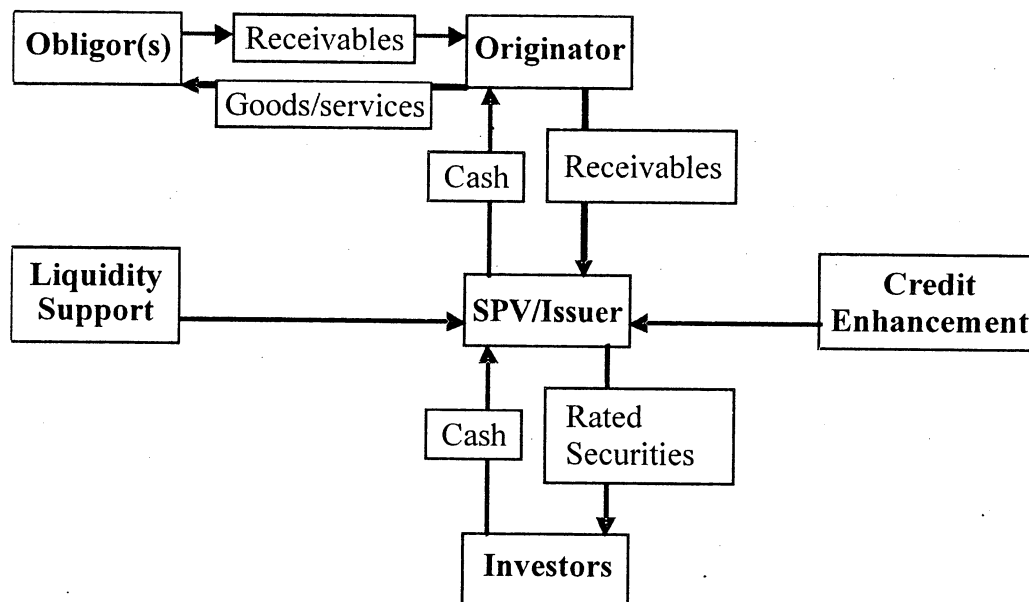
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The technique of securitization is a recent development in India and the pace of growth is not encouraging. One of the reasons may be lukewarm response of the investing community. The securitization process in India has come a long way since the widely reported first deal in 1990 when Citibank securitized auto loans and placed a paper with GIC mutual fund. Following this, the Hire-Purchase portfolio of TELCO was securitized by the Citibank. Since then, a variety of deals have been undertaken. Recently it was announced that HDFC will securitize housing loans receivables of around Rs.50 Crores through Infrastructure Leasing and Financial Services. The driving force for NBFCs to go for securitization has been to unlock the investment in all liquid assets, recycle the cash and exploit the new business opportunities.

## SECURITIZATION PROCESS

The process begins when the lender (or originator) segregates loans/lease/receivables into pools which are relatively homogenous in regard to types of credit, maturity and interest rate risk. The pools of assets are then transferred to a Special Purpose Vehicle (SPV) usually constituted as a trust. The originator may float the SPV as a subsidiary in the form of a limited company. Another option could be for the SPV to be floated jointly by the originator/individuals/banks/institutions who are interested in the securitization deal. Based on these, the SPV issues asset backed securities in the form of debt, certificates of beneficial ownership and other instruments. The securities issued may be with or without recourse. Interest and principal payments on the loans, leases and receivables in the underlying pool of assets are collected by the servicer (who could also be the originator) and transmitted to the investors.

The SPV finances the purchase of receivables by issuing securities (usually notes, commercial paper, bills, bonds, or preferred stock) to **investors**. Legal agreements delineate the rights and obligations of all parties to the transaction, including the appointment of an administrator to manage the receivables where necessary. One or more financial institutions are usually involved in structuring and marketing the securities issued by the SPV. To facilitate investor demand, credit rating agencies assess the likelihood that the SPV will default on its obligations and assign an appropriate credit rating. **Credit enhancement** and **liquidity support** is usually obtained by the SPV to ensure a high rating for the securities. The concept of securitization is best understood by considering a typical transaction.



Securitization takes place when a lending institution's asset are removed in one way or another from the balance sheet of that *lending institution* and are funded instead, by investors who purchase a negotiable instrument evidencing its indebtedness *without recourse*, or in some cases with limited recourse, to the original lender. **Following are the steps involved in the securitization process:**

**i) IDENTIFICATION STAGE:** It's the stage where banks or financial institution decides that which asset should be securitized depending upon the classification based upon the homogeneity of interest rate, maturity and frequency of repayments etc.

ii) **TRANSFER STAGE:** The classified assets are then passed through to another institution which is ready to help the organization to convert those assets into marketable securities. This institution is called "Special Purpose Vehicle" by way of a trust.

iii) **ISSUE STAGE:** Once the transfer process is over, the SPV splits the pool into individual shares and reimburses itself by selling these to investors. These securities are known as "pass-through-certificate" (PTC). These securities are predominantly without recourse to the originator.

iv) **REDEMPTION STAGE:** The redemption and payment of interest on these securities are facilitated by the collections received by the SPV from the securitized assets. The task of collection of dues is generally on the part of originator or a special serving agent can be appointed for this purpose for which certain commission is paid to the agency.

v) **CREDIT RATING:** To increase the marketability of the securitised assets in the form of securities, credit rating may be obtained by some reputed credit rating agency. It enhances the trading potential (liquidity) of the certificate. The investor's confidence is heightened owing to the third party objectivity of the rating agency.

**Example:** Consider a bank, ADC Bank. The loans given out by this bank are its assets. Thus, the bank has a pool of these assets on its balance sheet and so the funds of the bank are locked up in these loans. The bank gives loans to its customers. The customers who have taken a loan from the ADC bank are known as obligors. To free these blocked funds the assets are transferred by the originator (the person who holds the assets, ADC Bank in this case) to a special purpose vehicle (SPV). The SPV is a separate entity formed exclusively for the facilitation of the securitization process and providing funds to the originator. The assets being transferred to the SPV need to be homogenous in terms of the underlying asset, maturity and risk profile. What this means is that only one type of asset (eg: consumer loans) of similar maturity (eg: 24 to 36 months) will be classified together for creating the securitized instrument. The SPV will act as an intermediary, which divides the assets of the originator into marketable securities. These securities issued by the SPV to the investors and are known as pass-through-certificates (PTCs). The cash flows (which will include principal repayment, interest and prepayments received) received from the obligors are passed onto the investors (investors who have invested in the PTCs) on a pro rata basis once the service fees has been deducted. The difference between rate of interest payable by the obligor and return promised to the investor investing in PTCs is the servicing fee for the SPV.

## OBJECTIVES OF SECURITIZATION

Securitization is designed to offer a number of advantages to the seller, investor and debt markets. From the **originator's perspective**, securitisation provides benefits such as:

1. The receivables are moved "off balance sheet" and replaced by cash equivalent, thus improving the originator's liquidity, and balance sheet;
2. The originator does not have to wait till it receives payment of the receivables to obtain funds to continue its business and generate new receivables. This is more significant when the receivables are relatively long term, such as with real property mortgages, auto loans, student loans, etc.,
3. Securitisation lowers the firm's financing costs since the securities issued in the securitisation are more highly rated by rating agencies. This results into a lower interest rate for the originator, as investors do not demand the same risk premium.
4. Better assets liability management by reducing market risks resulting from interest rates mismatches.
5. To create room in the balance sheet to meet the capital adequacy norms prescribed by the regulatory authority
6. To increase return on equity by redeployment of the capital in higher yielding assets
7. Finally, transparency may be improved since securitization results in identifiable assets in the balance sheet.

For investor, securitization essentially provides an avenue for relatively risk-free investment. The credit enhancement provides an opportunity to investors to acquire good quality assets and to diversify their portfolios.

It also provides opportunity for matching cash flows and managing ALM since a securitized instrument carries regular monthly cash flows and has varying maturities. The prevalence of secondary markets would offer liquidity.

From the point of view of the financial system as a whole, securitization increases the number of debt instruments in the market, and provides additional liquidity in the market. It also facilitates unbundling, better allocation and management of project risks. It could widen the market by attracting new players on account of superior quality assets being available.

## **SECURITIZATION: AS A FUNDING STRATEGY FOR BANKS**

The pressure on capital in the Indian banking system continues on account of rapid credit growth over the last few years. Banks have responded to these challenges by issuing equity and hybrid capital, but room for raising additional capital is reducing rapidly. There are limits on the amount of hybrid capital that can be raised, and banks cannot continuously dilute their equity given the high cost of equity, and the issue of majority government ownership in public sector banks. The pressure on liquidity in the present economic scenario, coupled with increased provisioning and capital requirements, also gives rise to a need for a cost-effective and capital-efficient funding tool. The securitization offers an ideal solution to this difficult problem. It allows banks to churn their asset portfolios, reduce capital requirements, and gain access to more cost-effective funding. The capital requirements for securitization transactions too can be halved through efficient structuring. This would mean that a bank will be able to undertake larger volumes of business using the same amount of capital.

The assets of financial institutions include loans, bills receivables, trade receivables etc. These assets are financed through debt and equity. Securitization is a funding strategy that involves funding based on asset value and cash flow characteristics of the asset pool which are not supported by the firm's equity. A company generally raises funds through debt or equity and is shown on the liability side of the balance sheet. This method of raising funds is also termed as the left hand side of the balance sheet approach. Securitization is a right hand side of the balance sheet approach of raising funds based on the specific asset pool's cash flow and values. Usually funding is from new creditors whose recourse is restricted to the assets being financed. Intense competition, balance sheet management and high funding costs make exclusive reliance on the left hand side funding strategies both risky and costly. Firms can improve their liquidity position and improve certain key ratios like ROE and ROA through securitization. Securitization enables banks and institutions to borrow at a lower cost. An improvement in the liquidity position will lower working capital requirements and thus reduce the interest burden. The proceeds from securitization can also be invested in projects that give a higher rate of return, thus improving the overall performance of the institution.

## **BANKS EMPOWERED WITH SECURITIZATION ACT**

As we know the financial sector is essential to the growth of a nation and this sector has been one of the keys to India's efforts to achieve success in rapidly developing its economy. The banking sector has been striving to achieve international standards and is progressively complying with the international prudential norms and standards. Despite all this we have various areas where we don't enjoy level playing fields with the international banks and one of them has been the Menace of NPAs.

To fight the menace of the NPAs the Indian banks required more teeth. With an object to give the bank more powers and skill the government decided to bring in the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. The Securitization Act empowers the banks and FIs to move on its own against a borrower whose assets are secured, and who has made some kind of default in repayment of the same. The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law. Thus after complying with the statutory provisions in the said Act the banks can

- Take possession of the secured assets of the borrower. This includes the right to transfer by way of lease, assignment or sale of the same for realization of the secured debt.
- Take over the management of the secured asset including the right to transfer by way of lease, assignment or sale of the same for realization of the secured debt.
- Appoint any person to manage the secured asset.

Not only this, securitization also helps banks to sell off their bad loans (NPAs or non performing assets) to asset reconstruction companies (ARCs). ARCs, which are typically publicly/government owned, act as debt aggregators and are engaged in acquiring bad loans from the banks at a discounted price, thereby helping banks to focus on core

activities. On acquiring bad loans ARCs restructure them and sell them to other investors as PTCs, thereby freeing the banking system to focus on normal banking activities.

Asset Reconstruction Company of India Limited (ARCIL) was the first (till date remains the only ARC) to commence business in India. ICICI Bank, Karur Vyasya Bank, Karnataka Bank, Citicorp (I) Finance, SBI, IDBI, PNB, HDFC, HDFC Bank and some other banks have shareholding in ARCIL. A lot of banks have been selling off their NPAs to ARCIL. ICICI bank- the second largest bank in India, has been the largest seller of bad loans to ARCIL last year. It sold 134 cases worth Rs.8450 Crore. SBI and IDBI hold second and third positions. ARCIL is keen to see cash flush foreign funds enter the distressed debt markets to help deepen it. What is happening right now is that banks and FIs have been selling their NPAs to ARCIL and the same banks and FIs are picking up the PTCs being issued by ARCIL and thus helping ARCIL to finance the purchase.

Securitization is expected to become more popular in the near future in the banking sector. Banks are expected to sell off a greater amount of NPAs to ARCIL by 2007, when they have to shift to Basel-II norms. Blocking too much capital in NPAs can reduce the capital adequacy of banks and can be a hindrance for banks to meet the Basel-II norms.

## **SECURITIZATION : A WAY TO INFUSE LIQUIDITY**

Other than freeing up the blocked assets of banks, securitization can transform banking in other ways as well. The growth in credit off take of banks has been the highest in the last 55 years. But at the same time the incremental credit deposit ratio for the past one-year has been greater than one. What this means in simple terms is that for every Rs 100 worth of deposit coming into the system more than Rs 100 is being disbursed as credit. The growth of credit off take though has not been matched with a growth in deposits. Banks essentially have been selling their investments in government securities. By selling their investments and giving out that money as loans, the banks have been able to cater to the credit boom. This form of funding credit growth cannot continue forever, primarily because banks have to maintain an investment to the tune of 25 per cent of the net bank deposits in Statutory Liquidity Ratio (SLR) Instruments (government and semi government securities). The fact that they have been selling government paper to fund credit off take means that their investment in government paper has been declining. Once the banks reach this level of 25 per cent, they cannot sell any more government securities to generate liquidity. However with the excess SLR investments in the banking system decreasing to 28% of net demand and time liabilities (NDTL) by January 2007 (around 40% three years ago) as compared with the regulatory minimum of 25%, the banks will have to find alternate source of funds in order to meet the credit growth.

One way is obviously to increase interest rates. Another way is Securitization. Banks can securitize the loans they have given out and use the money brought in by this to give out more credit. A.K. Purwar, in a recent interview to a business daily remarked that bank might securitize some of its loans to generate funds to keep supporting the high credit off take instead of raising interest rates. To serve as a source of liquidity for the bank and to maximize the benefits, securitization should be carried out on a continuous basis. Through securitization the bank is provided with additional liquidity when it is needed and this source may be tapped into when the demand for cash increases.

In both cases, securitization firstly offers the benefit that the bank's profitability may improve due to the additional service income earned from servicing the securitized assets. Secondly, the bank's access to a liability source makes it less dependent on assets for liquidity. Thirdly, having a successful securitization programme, where assets can be sold on a continuous basis to the SPV to obtain funds, improves the bank's access to liquidity sources and the market's perception regarding the liquidity position of the bank. This may again, increase the bank's accessibility to other sources of liquidity that were previously not available to the bank. Finally, the cost of other sources of liquidity may decrease due to changing perceptions regarding the liquidity position of the bank.

## **SECURITIZATION ENVIRONMENT IN INDIA**

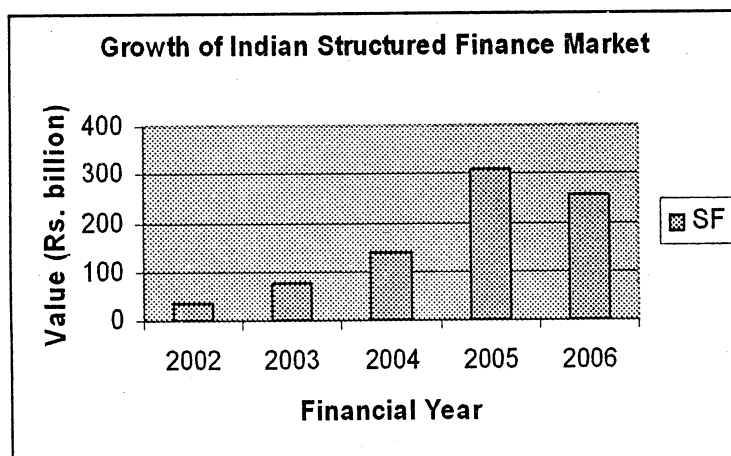
Securitization began in India in the early nineties. CRISIL rated the first securitization programme in 1991-92 when Citibank securitized a pool from its auto loan portfolio and placed the paper with GIC Mutual Fund. The volume involved was about Rs. 160 million. Since then, several structured transactions aggregating to a volume of over Rs. 123,000 million have been rated by CRISIL alone in India, of which transactions having rated, amounts of over Rs. 70,000 million are still in existence.

The market for securitization zoomed from 2002 to 2005, with a cumulative growth rate of nearly 100%. The following graph (1.1), taken from an ICRA report, shows the growth path of structured finance in India. Sometime back, Standard and Poor's reported the Asian securitization data for 2003, and it was a pleasant surprise to note that India was no. 2 in ex-Japan Asia in terms of volumes, next only after Korea. Though the gap between India and Korea is huge, but the Indian market continues to zoom through 2004. Data for the first half of 2004-05 (up to Sept 2004) revealed that the market has already crossed a volume of Rs. 10,000 crores in the half year, which is nearly 4 times the volume for the same period last year.

**Statistics of Indian structured Finance (Table 1.1)**

Year	2002	2003	2004	2005	2006
Volume (Rs Billion)	36.8	77.7	139.2	308.2	256.5
Number of Transaction	25	73	88	127	130

(Source ICRA estimates)

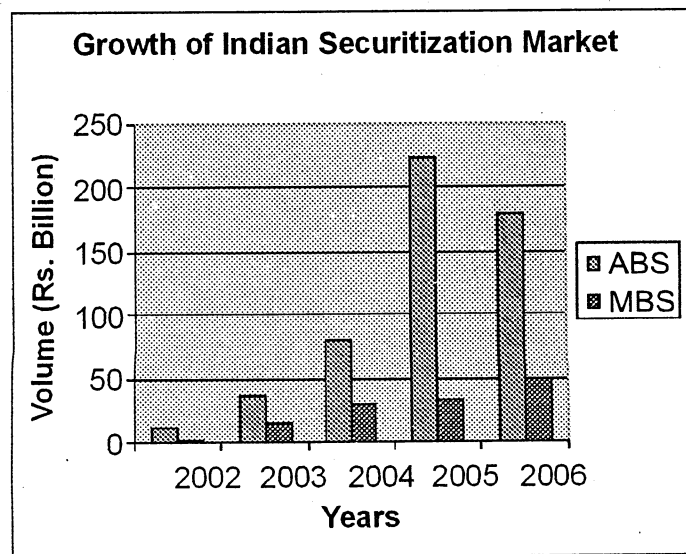


**Graph 1.1**

**Volumes (Rs. in billions) (Table 1.2)**

Year	2002	2003	2004	2005	2006
ABS	12.9	36.4	80.9	222.9	178.5
MBS	0.8	14.8	29.6	33.4	50.1

(Source ICRA estimates)



**Graph 1.2**

During Financial Year 2005 the market for the structured financial transactions in India grew by 121% over the previous year, in value terms. The increase in the number of transactions, however, was more modest at 41%, which points to a significant rise in the average deal size. The graph(1.2) shows the segregated market of ABS and MBS market. The ABS market showed the maximum growth on the back of a robust increase in retail lending by banks and non-banking finance companies (NBFCs). ABS continued to be the largest product class, accounting for 72% of the structured finance market in the year 2005. In the financial year 2005, relatively newer asset classes such as loans for financing used cars, three wheelers and two-wheelers also got securitized in a big way. The average ABS deal size almost doubled from Rs. 1.5 billion in 2004 to Rs.2.9 billion in 2005. This increase was caused mainly by the large pools securitized by leading vehicle financiers like ICICI Bank and HDFC Bank.

The MBS market was relatively slow during financial year 2005; reported issuances of Rs.33.4 billion reflect a 13% growth over the previous year. This was despite the largest ever MBS transaction in India – a Rs. 12 billion mortgage backed pool of ICICI Bank, which was rated by ICRA. Overall, growth in corporate loan securitization in India has been far lower than that in retail securitization.

## **SECURITIZATION OF RECEIVABLES IN BANKS**

The banks (especially the private sector banks and non banking finance companies) have been using securitization as an effective tool in booking upfront profits and also managing their liquidity. The issuance volume in the Indian structured finance (SF) market declined year-on-year by 17% to Rs. 256 billion during 2005-06 (since doubling each year since 2002-03) as the originators slowed down to weigh the implications of the draft guidelines on securitization issued by the RBI in April 2005. The tight liquidity conditions and the resulting rise in interest rates during the second half also contributed to the slowdown in securitization issuances. ICRA expects the final guidelines (issued in February 2006) to have a salutary effect on the domestic securitization market over the medium to long term. ICRA believes that strong growth and increasing capital adequacy requirements will continue to prompt retail finance players to securitize their assets. With the market appetite increasing for securitized debt, this can become an important avenue for all players in the Indian financial system to augment their funding base while also helping in managing the asset liability matters, liquidity.

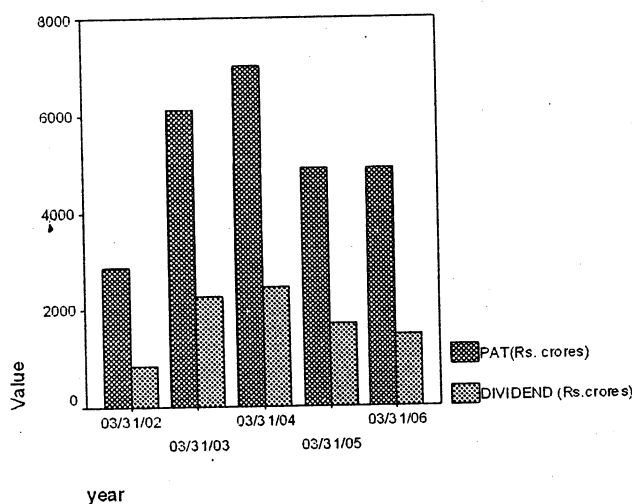
## **CONCLUSION**

Among the various innovations in financial markets, Securitization is among the best. It has arrived in a developing country like India much faster than expected. The generic benefits of securitization for originators and investors have been discussed earlier. These Benefits are possible but there are views that the securitization process, if not carried out prudentially, can leave risks with the originating bank without allocating capital to back them. While all banking activity entails operational and legal risks, these may be greater, the more complex the activity. It is felt that the main risk a bank may face in a securitization scheme arises if a true sale has not been achieved and the selling bank is forced to recognize some or all of the losses if the assets subsequently cease to perform. Also, funding risks and constraints on liquidity may arise if assets designed to be securitized have been originated, but because of disturbances in the market, the securities cannot be placed. There is also a view that there is at least a potential conflict of interest if a bank originates, sells, services and underwrites the same issue of securities. In the Indian context, securitization is the only ray of hope for funding resource starved infrastructure sectors like power. For power utilities burdened with delinquent receivables from state electricity boards (SEBs), securitization seems to be the only hope of meeting resource requirements. Securitization can help Indian borrowers with international assets in pricing the sovereign rating and placing an investment grade structure. A market for Mortgage backed Securities (MBS) in India can help large Indian housing finance companies (HFCs) in churning their portfolios and focus on what they know best fresh asset origination. Indian HFCs have traditionally relied on bond finance and loans from the National Housing Bank (NHB). MBS can provide a vital source of funds for the HFCs. There is large untapped market in housing loan portfolios, vehicle loans, credit card receivables, student loans, infrastructure projects, public utilities, tax deferrals etc, which can now be tapped. Major hindrances in the form of unclear taxation, accounting, legal and regulatory framework have also restricted the market to achieve its full potential. The success of securitization depends on whether a secondary market can be developed for the debt instruments like certificate of deposits, commercial papers etc. One of the main impediments in development of securitization market in India is the levy of stamp duties. Any securitization deal will have to pay hefty stamp duties thereby increasing the overall cost of the deal.

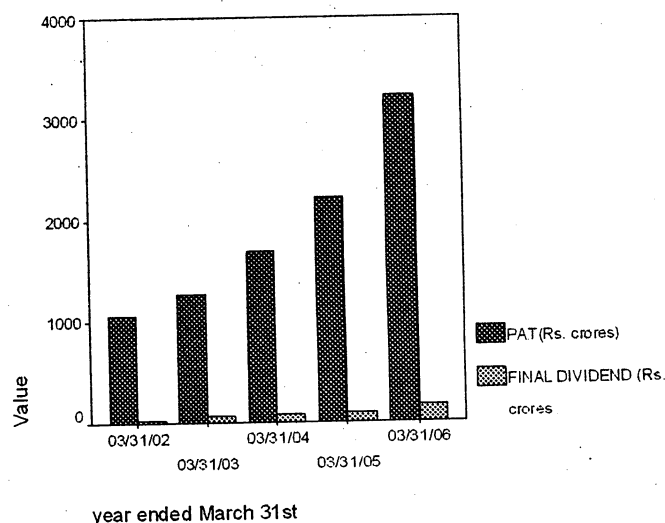
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(Contd. from page 12)



Bar chart showing dividend payment pattern of IOC (2001-2006)



Bar chart showing dividend payment pattern of Satyam computers (2001 to 2006)

tend to maintain smooth dividend payout patterns, they pay out stable amounts of dividends and avoid sudden changes especially cuts in dividends. Therefore the conclusion that we draw from this analysis is that Linter model remains the best description of dividend setting process of Indian firms. That is, the level of current and expected future earnings and a pattern of continuity are the most important determinants of dividend policy.

In this paper, we have also discussed how shareholders might approach dividend as an interactive game with management. But much remains unknown about how dividend policy can maximize shareholder value. The discussion on dividend policy needs to be pursued further so that both investors and management better understand its significance, impact, and optimization methods.

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