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Theme 244

FINANCIAL HOLDING COMPANY

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SIB STUDENTS' ECONOMIC FORUM

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Theme No. 244 : FINANCIAL HOLDING COMPANY

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "Forum". RBI has recently released the recommendations of the Working Group on introduction of Financial Holding Company Structure in India. We discuss on this topic this month.

What do you mean by a Financial Holding Company?

Presently Indian banks are organised under the subsidiary model, where each bank acts as the parent of all the subsidiaries. Under this model, the bank floats subsidiaries under them to undertake the non-banking financial activities. The universal model undertakes all the financial activities within a single entity. The concept of Financial Holding Company (FHC) has evolved as a preferred model drawing lessons from the global financial crisis. The design of an FHC is such that it acts as a financial institution engaged in non- banking activities that offers customers a wide range of financial services, including the opportunity to purchase insurance products and invest in securities.

What is the rationale behind constitution of the Working Group on FHC?

In India, the financial sector reforms have witnessed an upsurge in banking, capital markets and insurance industries leading to formation of conglomerates with complex structures. RBI constituted the working group in June 2010, headed by Smt. Shyamala Gopinath, the then Deputy Governor of RBI to examine the feasibility of introducing a Financial Holding company Structure in India. RBI wanted the Working Group to address the issues of conflict of interest and safety considerations for banks venturing in non-banking financial activities. The post crisis reform proposals do not specify preference for any particular model. The focus, as far as structure is concerned, is on strengthening capital requirements at the consolidated level; reducing complexity of structures to enable efficient resolution of financial institutions; and separation of investment banking from commercial banking.

What are risks involved in the Bank - Subsidiary Model?

Banks are allowed to undertake all such activities that are permitted under Section 6 (1) of the Banking Regulation Act. Within this broad scope, certain activities are to be undertaken only through a separate subsidiary due to the regulatory leverage on banks to maintain statutory reserves such as Cash Reserve Ratio and Statutory Liquidity Ratio. RBI wanted to address the issue of the regulatory comfort with various models. At present all non-banking activities have been undertaken by banks in India through a subsidiary route by floating separate subsidiaries. But this model imposes a burden on banks for equity infusion in future arising from expansion of business and to meet the regulatory capital requirement .The parent bank is directly exposed to the functioning of its subsidiaries and any losses incurred may adversely impact the bottom lines of banks. RBI views that the holding company structure may address the issues and ensure regulatory comfort and financial health of the subsidiaries.

What are the major terms of reference assigned to the Working Group?

1. To study the functioning of the various international holding company models in the financial sector.
2. To examine these structures from the larger perspective of regulatory/supervisory frame work in our country.
3. To compare the FHC structure with the existing structures in India.
4. To recommend a suitable holding company model within the extant regulatory /supervisory frame work most suited to Indian conditions.
5. To design a road map for the smooth implementation of the new model.
6. To examine the legal and taxation issues and suggest enactment / amendment of statutes.

How does the Working Group perceive a full - fledged FHC Model?

The Working Group recommends that the FHC model shall be the preferred model for all the financial groups – both bank and non-bank. The FHC model may be extended to all large financial groups-both a banking FHC controlling a bank and a non- banking FHC which does not include a bank in the group.

What is the regulatory frame work proposed?

Among the various possible options considered by the Group, the most desirable one seems to be a separate regulatory framework for Financial Holding Companies, over-reaching the existing functional regulation for various segments. The proposal is to engage a supervisory authority to assess how risks arising in one activity of an FHC affect the other portfolios. The ultimate aim is to ensure safety and soundness of the system. The Working Group reiterates the need of a separate regulatory frame work for FHCs . As such enactment of a separate Act, for regulation of FHCs, would be the most effective alternative. Such an initiative may avoid any legal uncertainties arising out of amendments in RBI Act or Banking Regulation Act for regulating the FHCs. The new Act may help in aligning the regulation of FHCs with the objectives of system. The new design of the regulatory framework may provide a face lift to the FHC model, which is different in scope and focus from the subsidiary model. The Working Group also suggests amendments simultaneously in other Statutes/Acts governing public sector banks, Companies Act and others, wherever necessary. Alternatively, in order to avoid separate legislation for amending all individual Acts, the provisions of the new Act should have the effect of amending all the relevant provisions of the individual acts and have over- riding powers over other acts in case of any conflict.

Who should regulate the FHC?

The Working group suggests that Reserve Bank should be designated as the regulator for Financial Holding Companies. The function of FHC regulation should be undertaken by a separate unit within RBI with staff drawn from both RBI as well as other regulators. The new FHC regulatory framework should also formalize a consolidated supervision mechanism through Memorandum of Understanding between regulators.

What are the proposals by the Working Group for an FHC structure in India?

Intermediate Holding companies within an FHC should not be permitted due to their contribution to the opacity and complexity in the organisational structure. The FHC should primarily be a non-operating entity and should be permitted only limited leverage as stipulated by RBI. However, it could carry out activities which are incidental to its functioning as an FHC. The FHCs should be permitted to carry out all financial activities through subsidiaries. The types of activity in which the FHCs should not engage or should engage only up to a limit, should be stipulated by RBI. The FHC should be well diversified and subjected to strict ownership and governance norms. The ownership norms could be applied either at the level of their FHCs or at the entity level, depending upon whether the promoters intend to maintain majority control in the subsidiaries wherever it is permissible as per law. Appropriate limits should be fixed on cross holding between different FHCs and between FHCs on one hand and the banks, NBFCs and other financial institutions outside the group. The cross holdings within each FHC group may be subjected to intra-group transactions and exposure norms. There should be some limit on the expansion of non-banking business after the existing financial group dominated by the banks migrate to FHC structure so that the banking business continues to remain as the dominant activity of the group and growth of banking is not compromised by these groups in favour of growth of non-banking business. Presently the banks' total investment in subsidiaries is capped at 20% of their net worth. Under the FHC structure, the allocation of equity capital by Banking FHCs to non-banking subsidiaries should also be capped at a limit as deemed appropriate by RBI to ensure that banking continues to be a dominant activity of the group. If the holding company is to function as an anchor for capital support for all its subsidiaries, requisite space needs to be provided to the holding company for capital infusion for its subsidiaries. In this context it is possible to envisage to have either a listed holding company with all its subsidiaries being unlisted or both holding company with all or some of its subsidiaries being listed depending on the objectives and strategy of the group and the prevailing laws and regulations on investment limits. Given the circumstances prevailing in India, listing can be allowed both at FHC level as well as the subsidiary level subject to suitable safeguards and governance/ownership norms prescribed by the regulators from time to time.

What are the recommendations regarding taxation?

1. Suitable amendments to various taxation provisions may be made to make the transition from bank subsidiary model to FHC model, tax and stamp duty neutral.
2. Dividends paid by the subsidiaries to the FHC may be exempt from the Dividend Distribution Tax (DDT) to the extent these dividends are used by the FHC for investment in other subsidiaries.

What are the recommendations on operational arrangements to be made till the enactment of FHC Act?

1. The FHC model may be made operational under the provisions contained in the RBI Act. The FHC accordingly will be registered as an NBFC with RBI which will frame a suitable regulatory frame work, as detailed in the report, to FHCs in consultation with other regulators.
2. All identified financial conglomerates having a bank within the group will need to convert to FHC model in a time bound manner, once the perquisites necessary to make the transition tax neutral are in place.
3. In case the above conglomerates do not want to convert to FHCs, they should be required to confine only to those activities which the banks are presently permitted by RBI to undertake departmentally. This would mean that such conglomerates should eventually divest their holding in their subsidiaries.
4. For all other banking groups, conversion to the FHC model may be optional till the enactment of the FHC Act.
5. All non- banking financial conglomerates may have the option to convert to the FHC model. Those having insurance companies and do not adopt the FHC model should comply with the extant regulations regarding promoters stipulated by Insurance Regulatory and Development Authority (IRDA).
6. It may be mandatory for all banks and insurance companies, as and when licensed, to operate only under the FHC frame work.
7. Amendments to various taxation provisions to make the transition from bank subsidiary model to FHC model tax neutral should be a binding condition for making this frame work operational.

BANKING HOLDING COMPANY:

owns or controls one or more banks under a single regulator

FINANCIAL HOLDING COMPANY:

owns or controls banks and non-bank financial companies (NBFC) as well. Each NBFC may come under a different regulator or may not have a regulator at all.

FINANCIAL HOLDING COMPANY(INDIA):

Once the enactment is made, in the case of an FHC in India, Bank would be regulated by RBI, Asset Management Company by SEBI, Investment banking again by SEBI and insurance by IRDA.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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