PRESS RELEASE

RESERVE BANK OF INDIA
www.rbi.org.in
www.rbi.org.in\hindi
e-mail: helpprd@rbi.org.in

PRESS RELATIONS DIVISION, Central Office, Post Box 406, Mumbai 400001
Phone: 2266 0502 Fax: 2266 0358, 2270 3279

August 27, 2007

RBI Discussion Paper on Holding Companies in Banking Groups

The Reserve Bank of India today placed on its website discussion paper on holding companies in banking groups for comments from the public. Comments may be sent within three weeks to Chief General Manager-in-Charge, Department of Banking Operations and Development, Reserve Bank of India, Central Office , Shahid Bhagat Singh Marg, Mumbai- 400 001 or may be emailed.

It may be noted that in many countries, deregulation and financial consolidation have led to the development of Financial Holding Companies-allowing commercial banking, insurance, investment banking and other financial activities to be conducted under the same corporate umbrella. There are several ways of conducting different financial services in the same organisation using different conglomerate models, viz., the *Universal Bank, t*he *Bank Subsidiary Model* and *the Bank Holding Company model.*

The financial services sector in India has been witnessing a growth in the emergence of financial conglomerates. With the enlargement in the scope of the financial activities driven by the need for diversification of business lines to control the enterprise-wide risk, some of the players are experimenting with structures so far unfamiliar in India. In this context, it is considered opportune to take a review of some of the conglomerate structures and assess their suitability for the country given the prevailing legal, regulatory and accounting framework and highlight the regulatory and supervisory concerns emanating from such structures. The Reserve Bank of India has prepared the discussion paper on holding companies in banking groups in this context. The Reserve Bank would take a policy view in the matter based on the comments received.

Alpana Killawala
Chief General Manager

Press Release: 2007-2008/290

ANNEX

Holding Companies In Banking Groups

In many countries, deregulation and financial consolidation have led to the development of Financial Holding Companies—allowing commercial banking, insurance, investment banking, and other financial activities to be conducted under the same corporate umbrella[1]. There are several ways of conducting different financial services in the same organization -

- The *Universal Bank* as currently practiced in Germany, where all financial services are done within the bank;
- The *Bank Subsidiary Model*, where non-banking activities are done in separately constituted subsidiaries of the bank;
- The *Bank Holding Company model*, where non-banking activities are done in firms owned by a parent company that also owns the bank.

All the above conglomerate models can have one or more layers of intermediate holding companies.

The financial services sector in India has also been witnessing a growth in the emergence of financial conglomerates. With the enlargement in the scope of the financial activities driven by the need for diversification of business lines to control the enterprise-wide risk, some of the players are also experimenting with structures hitherto unfamiliar in India. In this context, it is considered opportune to take a review of some of the conglomerate structures and assess their suitability for the country given the prevailing legal, regulatory and accounting framework and highlight the regulatory and supervisory concerns for the Reserve Bank emanating from such structures.
This paper is structured into the following sections:

1. International experience regarding Financial Holding Companies(FHC)/Bank Holding Companies(BHC)
2. Major types of financial holding companies structures
3. Major motivations for BHCs/FHCs in India
4. Issues regarding introduction of BHCs/FHCs in India
5. Financial Conglomerates with intermediate holding companies

1. International experience regarding Financial Holding Companies(FHCs) /Bank Holding Companies(BHCs)

1.1 Internationally there are mainly two holding company models for bank related conglomerates viz, BHC Model and FHC Model.

1.2 BHC Model: *BHCs are companies that own or control one or more banks.* In USA these are regulated by the Federal Reserve. These companies were first introduced in Bank Holding Company Act of 1956. These companies can make only limited investments in the non-banking companies.

1.3 FHC Model: *FHCs are companies that own or control one or more banks or non-bank financial companies.* In USA, FHCs were created by the Gramm-Leach-Bliley Act as a way to expand the financial services activities of BHCs. GLB permits banks, securities firms and insurance companies to affiliate with each other through the FHC structure. FHCs can engage in activities other than banking as long as they are financial in nature. The most important of these are securities underwriting and dealing, insurance underwriting, insurance agency activities and merchant banking. The requirement to have bank in the financial group is pre-requisite for qualifying as an FHC in USA.

1.4 Spurred by the passage of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (GLB), many leading financial services companies are now doing business across sectors[2]. At present there are more than 600 FHCs in USA. Most of them are the BHCs which have elected to become FHCs under the GLB Act. FHCs control approximately 80% of the entire banking system in USA.

1.5 Other than USA, Canada, UK, Japan, France and some Emerging Asia countries such as Taiwan, Korea, Singapore and Hong Kong also have the FHC as a model of organization.

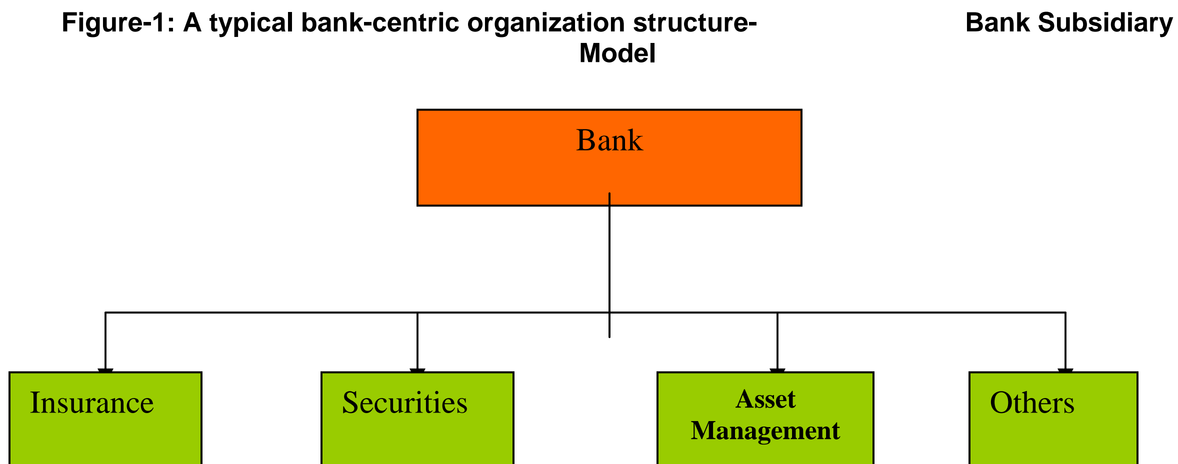
1.6 Financial conglomerates have developed primarily over the second half of the twentieth century, and have become particularly important in recent years. The principal economic benefits from conglomerate are the ability to capture potential economies of scale and scope and to capture synergies across complementary financial services business lines. These economies result in improved operational efficiency and effectiveness due to lower costs, reduced prices, and improved innovation in products and services. While the empirical benefits of forming such financial conglomerate structures may be uncertain, these organizations have gained in prominence in recent years. Nevertheless, there appears to be a consistent trend towards increasing conglomeration in many countries. A general trend towards deregulation of the financial

sector has played a major role in this process. Some observers have even asserted that regulatory authorities have encouraged consolidation in the financial services industry in order to facilitate enhanced diversification, capitalization, and investments in banking information technology, and to lessen the supervisory burden where banking organizations are larger and more visible (and thus open to increased public scrutiny).

2. Major types of financial holding companies structures

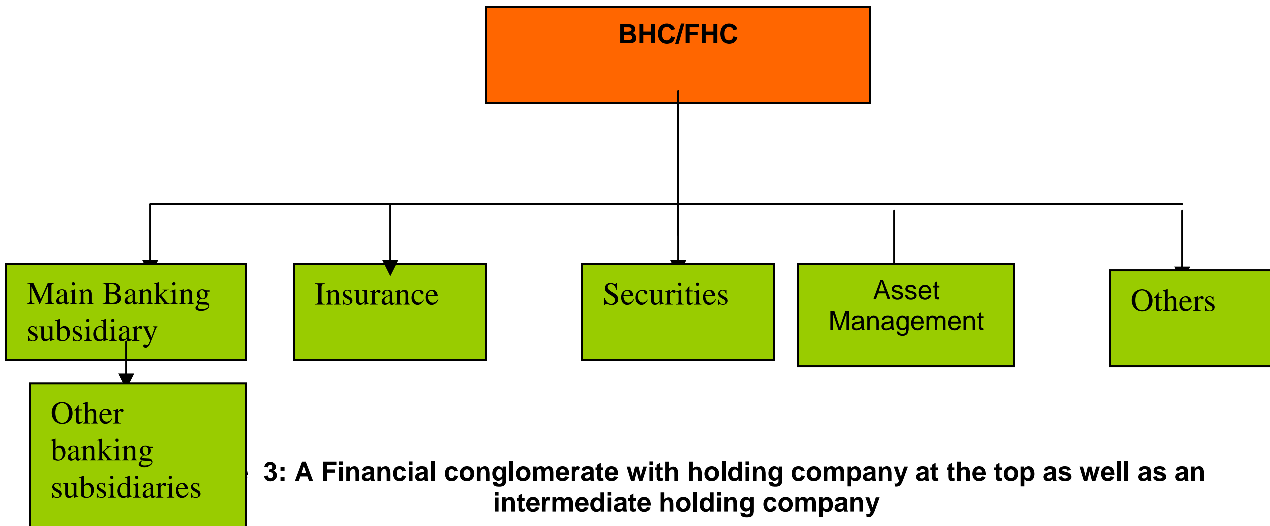
2.1 A typical bank-centric organization structure, which is currently followed in India is shown in Figure 1.

Figure-1: A typical bank-centric organization structure- Bank Subsidiary Model

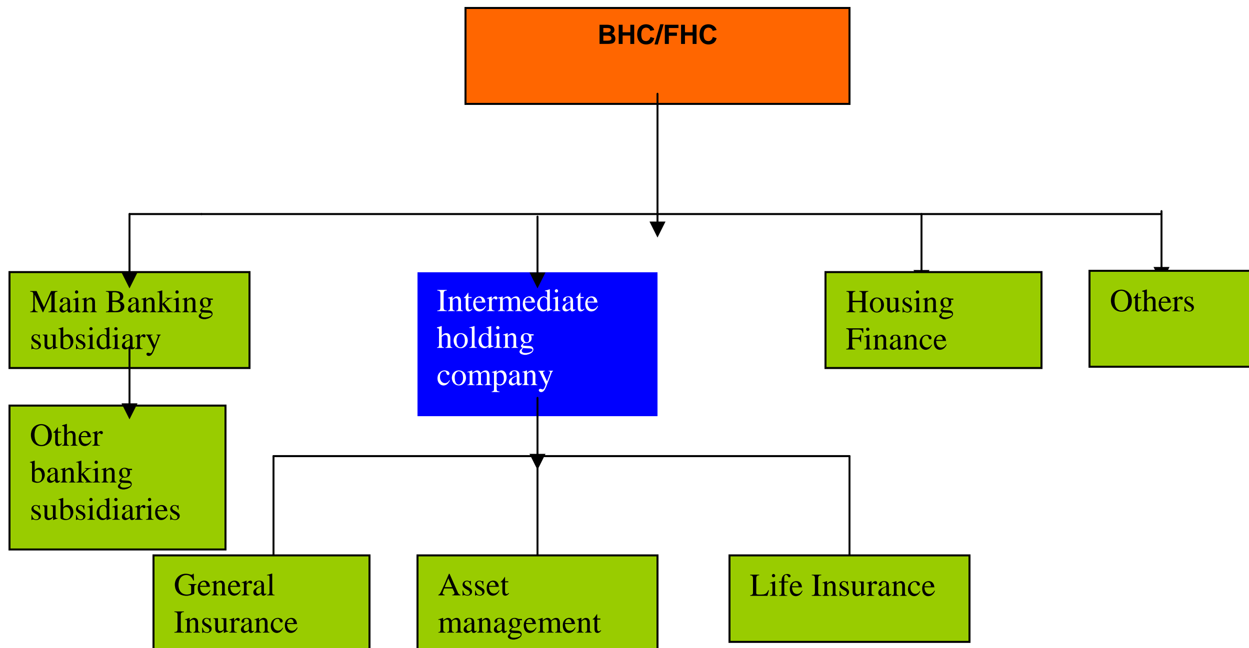


2.2 In a banking or financial group, a holding company can be the parent of the group or an intermediate holding company. A multi-layered financial conglomerate may also have a few tiers of intermediate holding companies apart from the holding company at the top. Organisational structure of a typical FHC with a main banking subsidiary, other banking subsidiaries and other non-banking financial subsidiaries is given in Figure 2. Figure 3 illustrates a financial conglomerate with a parent holding company and also an intermediate holding company.

Figure 2: A Financial conglomerate with holding company at the top



3: A Financial conglomerate with holding company at the top as well as an intermediate holding company



3. Major motivations for BHCs/FHCs in India

3.1 In terms of existing instructions, a bank's aggregate investment in the financial services companies including subsidiaries is limited to 20% of the paid up capital and reserves of the bank. In a BHC/FHC structure, this restriction will not apply as the investment in subsidiaries and associates will be made directly by the BHC/FHC. Once the subsidiaries are separated from the banks, their growth of the subsidiaries/associates would not be constrained on account of capital.

3.2 In the context of public sector banks, the Government holding through a BHC/FHC will not be possible in the existing statutes. However, if statutes are amended to count for effective holding then, the most important advantage in shifting to BHC/FHC model would be that the capital requirements of banks' subsidiaries would be de-linked from the banks' capital.

3.3 Since the non-banking entities within the banking group would be directly owned by the BHC, the contagion and reputation risk on account of affiliates for the bank is perceived to be less severe as compared with at present.

4. Issues regarding introduction of BHCs/FHCs in India

4.1 Legal Issues for BHCs/FHCs for India

(i) Need for a separate law

Some countries have a separate legislation for regulating BHCs/FHCs. If we have to have only BHCs, the purpose could be achieved perhaps even by amending the BR Act, 1949. However, in case it is decided to go for FHCs by expanding the scope of permissible financial activities by including all possible financial services, a separate Act on the lines of GLB in USA may be required.

(ii) Minimum threshold for recognizing a BHC for regulatory purposes

In USA, a BHC is a company which

a) directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of a bank or

b) controls in any manner the election of a majority of the directors or trustees of the bank[5].

A suitable threshold will have to be incorporated in the proposed statute.

(iii) Permissible activities of BHCs / FHCs

Internationally, there are restrictions on the activities of BHCs or FHCs[6]. While BHCs are not allowed to invest in non-banking related activities, subject to certain exceptions, restrictions in the case of FHCs mostly relate to investments in non-financial commercial enterprises. Further, the BHCs and FHCs are required to be non-operating in nature. Appropriate, restrictions on these lines will have to be prescribed by us.

iv) Cross holdings among BHCs/FHCs

Cross holdings among BHCs would create intractable regulatory problems. Some limits would be necessary in this regard.

4.2 Regulatory issues relating to BHCs/FHCs

(i) Capital adequacy framework

Basel-II norms

Capital adequacy framework for BHCs/FHCs would be governed as per Basel-II norms. The capital adequacy framework would be applicable to the BHC at consolidated level wherever the entire group would qualify as the **'banking group'.** (*If more than 50% of the group's assets are banking assets and more than 50% of the income is derived from the banking activities)*[7]. In other cases, the capital adequacy would be applied at the banking subsidiary level. A diagrammatic representation of the Scope of Application of Capital Adequacy Framework under Basel-II is given in Appendix.

Joint Forum's Capital Adequacy Principles for Financial Conglomerates

The Capital Adequacy Principles paper included in the Joint Forum's Report on Supervision of Financial Conglomerates[8] lays down detailed norms for assessment of capital adequacy of financial conglomerates. The main focus of the Forum's paper is to eliminate the double/ multiple gearing of capital within a financial group. Basel-II capital adequacy is largely consistent with approach outlined by the Forum and there would no additional issue in case of proposed BHCs in India.

(ii) Regulation of the BHC/FHC

While in the USA, BHCs and FHCs are necessarily regulated, in some jurisdictions these could be **unregulated.** Such conglomerates pose significant challenges to financial sector regulators. bank regulators. Therefore, the BHCs/FHCs in India should be made regulated entities by law. Further, the primary supervisor of the BHC should be RBI as in the case of USA.

(iii) Presence of unregulated entities within the BHC/FHC

The presence of any **unregulated** entity within the BHC/FHC structure especially an **unregulated** intermediate holding company may prove to be a weaker link in the entire structure providing scope for regulatory arbitrage. Therefore, it needs to be ensured that the BHCs/FHCs are, by law, not permitted to invest in any **unregulated** entity.

(iv) Cross-holdings among the subsidiaries of the BHC

Suitable cross holding restrictions for the intra-group(within BHC) as well as inter-group (Inter-BHCs) transactions will have to be prescribed.

It may be observed that the BHC/FHC structures could be useful in Indian context with a caveat that suitable statutory framework is created *a priori* and unregulated entities within the structure are avoided. However, intermediate holding companies could pose significant difficulties to supervision of the conglomerates especially if these are unregulated. Various issues relevant in this context are discussed in the following section.

5. Financial Conglomerates with intermediate holding companies

5.1 Reasons for corporates in setting up intermediate holding companies

The organizational model involving intermediate holding companies has been mainly used by multinational corporations to take tax advantage by setting up the intermediate holding companies in tax havens. The intermediate holding companies have also been used for regulatory arbitrage. An intermediate holding company or companies are key building blocks for achieving a multi-layered corporate structure. An intermediate holding company can find place in all the three basic types of conglomerates mentioned in the introductory Section of the paper.

5.2 Concerns relating to intermediate holding companies

A. General concerns

i) Governments and Financial Sector Regulators have always been concerned about the multi-layering of a corporate structure through a web of special purpose entities and intermediate holding companies. Particularly, the bank supervisors have viewed them as an impediment to effective supervision[9]. The problem of regulators becomes accentuated if the intermediate companies do not fall within their regulatory ambit[8].

ii) The Financial conglomerates especially the ones involving multi-layered companies with intermediate holding companies incorporated in different jurisdictions, tend to be large as they are involved in number of activities. While on the one hand the top holding company starts losing the grip on the step-down subsidiaries, the regulators some time feel the need to extend liquidity support of financial safety net beyond usual measures to prevent system wide financial crisis. This gives the market participants a feeling that when a crisis hits an institution that is 'too big to fail', the regulator would come to the rescue regardless of the circumstances that led to the crisis. Such perceptions coupled with the fact that complex financial institutions are also susceptible to the problem of weak internal controls, lack of flexibility and poor integration, ultimately result in weaker regulatory and supervisory control. It becomes really challenging and cumbersome for the regulators to supervise and assess the possible second order effects arising out of multi-layered complex structures. Nassim Nicholas Taleb in his book entitled " The Black Swan", has vividly highlighted the multiplicative and magnifying effect attributed to increase in the domain of the material variables, through example of "The Three Body Problem". He goes on to explain that as a dynamic system incorporates more and more layers of variables, the complexity of the system multiplies thereby impacting the quality of precision and forecasting exponentially. Consequently, the error grows out disproportionately.

(iii) The multi-layering of corporate structure is not considered good from investors' point of view as they do not really know where the money invested by them would be eventually used. Thus, it becomes difficult for them to assess the true risk involved in their investments[10].

(iv) The Joint Forum’s Report on Supervision of Financial Conglomerates contains a specific recommendation that the group–wide capital adequacy measurement technique used should effectively eliminate the effect of intermediate holding companies and yield the same results as would be produced if there were no such intermediate holding companies, or if it were consolidated in the relevant sector for risk assessment purposes[8].

(v) While the impact of multiple gearing of capital through holding companies can be effectively eliminated through consolidation, the challenging issue would be the ‘excessive leverage’ by the downstream affiliates if the intermediate holding company issues debt not qualifying for its capital instruments, but downstreams the proceeds to a dependent in the form of equity or other elements of regulatory capital. Excessive leverage can constitute a prudential risk for the regulated entity if undue stress is placed on the regulated entity resulting from the obligation on the parent to service that debt. A similar problem can arise where a parent issues capital instruments of one quality (e.g Tier II capital instruments) and downstreams them as instruments of a higher quality(Tier I capital instruments).

(vi) Apart from increasing the regulatory burden, the legal framework of the jurisdictions allowing such structures especially the bankruptcy/restructuring laws / procedures, capabilities of the accounting and audit profession have to be suitably upgraded.

(vii) The structure involving intermediate holding companies within a conglomerate principally organized on Bank Subsidiary Model will not completely insulate the bank from the capital burden of the subsidiaries.

B. India Specific concerns

i) If the intermediate holding company confines its investments to the shares of group companies only and does not carry out any other financial activities, which is likely to be the case in most of the times, it would not require registration under Section 45-I A of the RBI Act and would therefore not come under the regulatory purview of Department of Non-Banking Supervision of Reserve Bank of India. Presence of an unregulated intermediate holding company will raise concerns about the supervision of banking groups, as highlighted in para A above.

(ii) In a Bank Subsidiary conglomerate model which is presently being followed in India, the intermediate holding companies especially those combining non-banking subsidiaries/associates of the parent bank, will pose specific difficulties. For instance, there can be an intermediate holding company under a parent bank which combines four subsidiaries engaged in insurance, asset management, stock broking and housing finance activities. While all these subsidiaries will be regulated by different regulators (IRDA,SEBI and NHB) on solo basis, as the parent is a bank, the overall supervisory responsibility for the entire group including that for the subsidiaries of the intermediate holding company will rest with RBI. Thus, while the bank will be able to avoid the present 20% regulatory limit on investment in the financial services companies, RBI's regulatory concerns on account of the over extension of the bank group and increase in corresponding reputation risk, will continue. As stated earlier, these concerns will be accentuated if the holding company is unregulated, which it is likely to be under the existing regulations, as RBI may have difficulty in obtaining crucial information from the intermediary holding company as also in enforcing any prudential behavior required of such an intermediate holding company. The regulatory concerns mentioned above would be relevant even in the case when an unregulated intermediate holding company is inserted in a BHC/FHC model.

(iii) Another possible complication can arise because of legal restrictions on foreign holding in some subsidiaries like insurance companies. In insurance companies, the direct or indirect foreign holding cannot exceed 26%. However, when the Indian promoter company is a banking company, the proportion of foreign holding in such a banking company would **not** be taken into account for the purpose of calculating 26% cap of foreign holding in Indian insurance company in view of Regulation 11 (1) (g) (iii) of IRDA Regulations. In the intermediate holding company structure, the insurance company would be a subsidiary of the intermediate holding company, which in turn would be a wholly owned subsidiary of the bank, the above exemption would not be allowed. Though it might be within the power of the concerned regulator to give a ruling in favour of the intermediate holding company structure, it might still be open to legal review.

6. It may be seen from the above that there are considerable advantages in having FHC/BHC structure in as much as the banks would be much better protected from the possible adverse effects from the activities of their non-banking financial subsidiaries. Infact, it may also be possible to consider allowing non banking subsidiaries under the FHC/BHC structure to undertake riskier activities hitherto not allowed to bank subsidiaries such as commodity broking.

In the above context, it will be useful to explore the possibility of adopting a BHC/FHC Model. However, a proper legal framework needs to be created before such structures are floated and it is ensured that no unregulated entities are present within the structure.

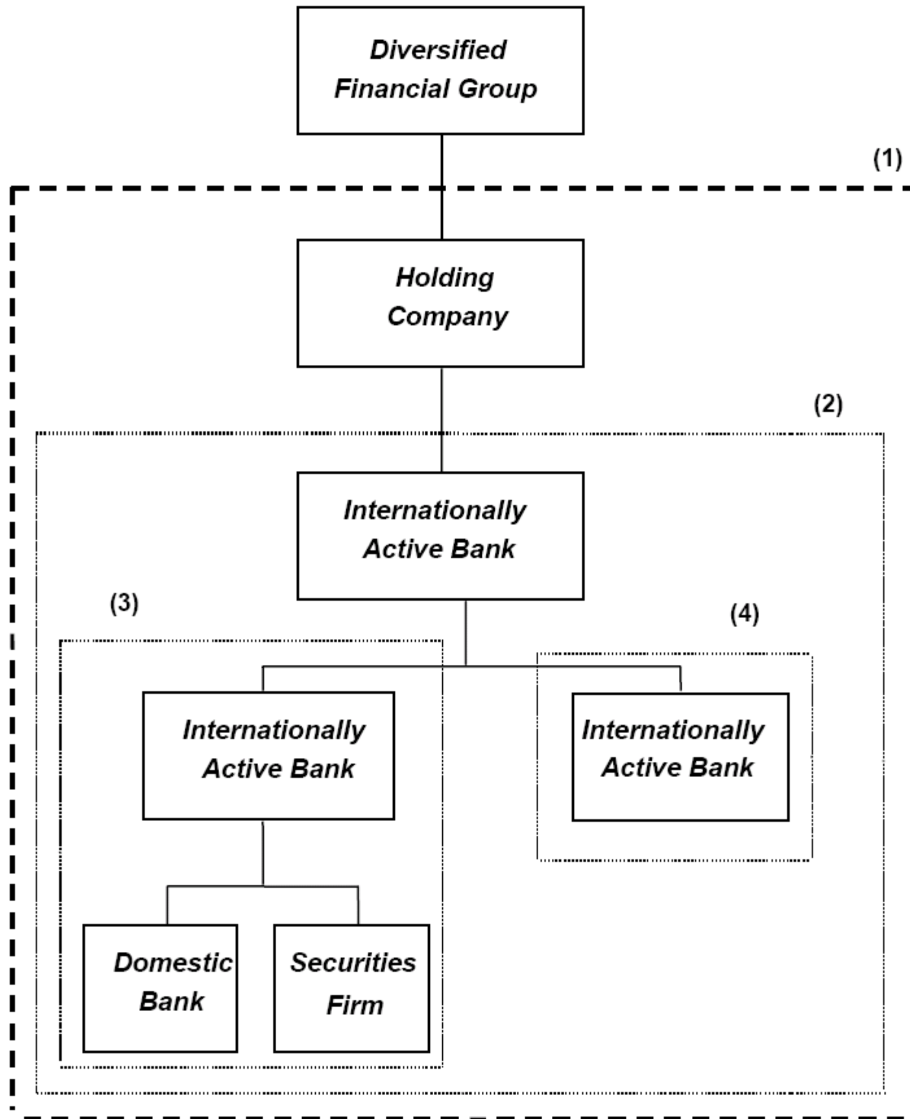
In the above context, it will be useful to contain the complexity in the BHC/FHC Model as also in the Bank Subsidiary Model of conglomeration to the bare minimum. Towards this end, it will be desirable to avoid intermediate holding company structures.

References:

1. Umbrella Supervision by Joseph G. Haubrich and James B. Thomson, Federal Reserve Bank of Cleveland
2. Financial Services Fact Book, Insurance Information Institute, New York,
3. Evolving Trends in the Supervision of Financial Conglomerates: A Comparative Investigation of Responses to the Challenges of Cross-Sectoral Supervision in the United States, European Union, and United Kingdom, Cameron Half, Harvard Law School , International Finance Seminar, Professors Howell Jackson and Hal Scott, April 30, 2002.
4. Presentation made by JP Morgan to DBOD, RBI.
5. Bank Holding Company, Supervision Manual, Federal Reserve, New York, USA
6. Financial Holding Companies: Bill C-8 and New Options for Financial Conglomerates (in Canada)
7. FSI Connect, FSI
8. Supervision of Financial Conglomerates, Joint Forum, February 1999.
9. Principles For The Supervision Of Banks' Foreign Establishments (May 1983)

10. Informal Workouts, Restructuring and the Future of Asian Insolvency Reform, Proceedings from the Second Forum for Asian Insolvency Reform - December 2002, CENTRE FOR CO-OPERATION WITH NON-MEMBERS, OECD

Appendix



(1) Boundary of predominant banking group. The Framework is to be applied at this level on a consolidated basis, i.e. up to holding company level (paragraph 21).

(2), (3) and **(4)**: the Framework is also to be applied at lower levels to all internationally active banks on a consolidated basis.