प्रेस प्रकाशनी PRESS RELEASE

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वेबसाइट : www.rbi.org.in/hindi
Website: www.rbi.org.in
इ-मेल email: helpdoc@rbi.org.in

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई-400001
DEPARTMENT OF COMMUNICATION, Central Office, S.B.S.Marg, Mumbai-400001
फोन/Phone: 91 22 2266 0502 फैक्स/Fax: 91 22 2266 0358

May 23, 2011

RBI releases Report of the Working Group on Introduction of Financial Holding Company Structure in India

The Reserve Bank of India today placed on its website the Report of the Working Group on Introduction of Financial Holding Company Structure in India (Chairperson: Smt. Shyamala Gopinath). Comments on the Report may please be emailed or forwarded by end-June 2011 to the Chief General Manager-in-Charge, Department of Banking Operations and Development, Reserve Bank of India, Central Office, Mumbai 400 001.

The key recommendations of the Working Group are:

- The financial holding company (FHC) model should be pursued as a preferred model for the financial sector in India.
- The FHC model can be extended to all large financial groups – irrespective of whether they contain a bank or not. Therefore, there can be banking FHCs controlling a bank and non-banking FHCs which do not contain a bank in the group.
- There should be a separate regulatory framework for financial holding companies.
- A separate new Act for regulation of financial holding companies should be enacted.
- Amendments should also be simultaneously made to 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 for FHCs should have the effect of amending all the relevant provisions of individual Acts and have over-riding powers over other Acts in case of any conflict.
- The 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 the Reserve Bank with staff drawn from both the Reserve Bank as well as other regulators.
- The new FHC regulatory framework should also formalise a consolidated supervision mechanism through Memorandum of Understanding between regulators.
- Intermediate holding companies within the FHC should not be permitted due to their contribution to the opacity and complexity in the organiational structure.

- The FHC should primarily be a non-operating entity and should be permitted only limited leverage as stipulated by the reserve Bank. 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 activities in which the FHCs should not engage or should engage only upto a limit, e.g., commercial activities, should be stipulated by the Reserve Bank.
- The FHC should be well diversified and subject to strict ownership and governance norms. The ownership restrictions 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. There should also be limits on cross holding between FHCs on one hand and banks, NBFCs, and other financial institutions outside the group. The cross holding among the entities within the FHC group may be subjected to intra-group transactions and exposure norms.
- It would be necessary to put in place some limit on the expansion of non-banking business after the existing financial groups dominated by the banks migrate to holding company structure (Banking FHCs) so that the banking business continues to remain 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 its subsidiaries is capped at 20 per cent 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 the Reserve Bank 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 would need to be provided to the holding company for capital raising 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 the holding company with all or some of its subsidiaries being listed depending on the objectives and strategy of the financial group and the prevailing laws and regulations on investment limits. Given the circumstances prevailing in India, listing can be allowed both at the FHC level as well as the subsidiary level subject to suitable safeguards and governance/ownership norms prescribed by the regulator/s from time to time.
- 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.
- Dividends paid by 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.
- The FHC model may have to be phased in gradually over a period taking into account the specific challenges. Accordingly, the following operational scheme is recommended:
    - ❖ Pending enactment of a separate Act, the FHC model may be operationalised under the provisions contained in the Reserve Bank of India Act. The FHC, accordingly, will be registered as an NBFC with the

Reserve Bank which will frame a suitable regulatory framework, as detailed in the report, for FHCs in consultation with other regulators.

- ❖ All identified financial conglomerates having a bank within the group will need to convert to FHC model in a time bound manner, once the pre-requisites necessary to make the transition tax neutral are in place.
- ❖ 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 the Reserve Bank to undertake departmentally. This would mean that such conglomerates should eventually divest their holding in their subsidiaries.
- ❖ For all other banking groups, conversion to the FHC model may be optional till the enactment of the FHC Act.
- ❖ 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).
- ❖ All new banks and insurance companies, as and when licensed, will mandatorily need to operate under the FHC framework.
- ❖ Amendments to various taxation provisions to make the transition from Bank-Subsidiary model to FHC model tax neutral would be a binding condition for operationalising this framework.

Background

The Reserve Bank of India (RBI) constituted the Working Group in June 2010 to examine the feasibility of introducing a Financial Holding Company Structure in India under the chairpersonship of Smt. Shyamala Gopinath, Deputy Governor. Members of the Working Group were drawn from the Ministry of Finance, Securities and Exchange Board of India, IRDA, Indian Banks' Association, banks and the Reserve Bank.

The Working Group was assigned the following terms of reference:

- To study the different Holding Company structures internationally in the financial sector;
- To examine these structures including Financial Holding Company (FHC) structure, their advantages and suitability from the regulatory/supervisory perspective in the Indian context compared to the existing structures in India;
- To recommend a suitable Holding Company framework for India and the required regulatory and supervisory framework;
- To lay a roadmap for adoption of the recommended Holding Company framework;
- To examine the legal and taxation issues involved and suggest enactment of statues/amendment to the existing statutes; and
- To examine any other relevant issues.

Alpana Killawala
Chief General Manager

Press Release: 2010-2011/1701