Financial Institutions Group
Commercial Banks
Equity – India

Indian Banks

Is India prepared for holding company structure in banks?

- **RBI releases discussion paper on holding company for banks' subsidiaries in life insurance, asset management, and others**
- **Multiple reasons cited to avoid the 'intermediate holding company' structure; prefers financial holding company or bank holding company model after creating legal framework**
- **We view this as generally bad news for those Indian financial stocks that have been driven, in part, by expectation of value unlocking, catalysed by creation of a holding company**

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Anand Shanbhag *
Analyst
HSBC Securities and Capital Markets (India) Private Limited
+91 22 2268 1234
anandshanbhag@hsbc.co.in

Saumya Agarwal *
Analyst
HSBC Securities and Capital Markets (India) Private Limited
+91 22 2268 1235
saumyaagarwal@hsbc.co.in

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RBI lists the concerns

Today, the Reserve Bank of India published a discussion paper on holding companies in banking groups. This 11-page document follows approvals sought from RBI by a few banks to transfer their majority stakes in unlisted insurance and asset management subsidiaries to a new subsidiary that would act as the holding company for these non-bank businesses.

The paper discusses types of holding company structures followed in other countries, motivations for creating a holding company in India, legal issues in India and regulatory issues such as the capital adequacy framework, regulation of the holding company, presence of unregulated entities within the holding company, and cross-holdings among the subsidiaries.

It ends with the statement, ". . . it will be desirable to avoid intermediate holding company structures". These are the structures that are believed to have been proposed by some of the Indian banks. RBI seems to prefer the alternatives of a financial holding company (FHC) or a bank holding company (BHC) to an intermediate holding company. Yet the discussion paper also states the need to create a proper legal framework before FHC/BHC structures are floated in India to ensure that no unregulated entities are present within the structure.

RBI has invited comments on the paper for a period of three weeks.

Concerns expressed by the RBI

General concerns

- Impediment to effective supervision. This could arise from multi-layering a corporate structure through a web of special-purpose entities and intermediate holding companies. This is accentuated if the intermediate company falls outside the regulatory ambit.
- Weaker regulatory and supervisory control of financial conglomerates. The concern is that the top holding company could lose grip on step-down subsidiaries, and regulators may need to extend support beyond the usual measures to prevent a system-wide financial crisis.
- Not good for investors, who may not know where the conglomerate deploys capital.
- Preference for a group-wide capital adequacy structure that should effectively eliminate intermediate holding companies by producing the same result as when there are no intermediate holding companies.
- Potential for excessive leverage by downstream affiliates if the intermediate holding company issues debt not qualifying for capital instruments but "downstreams" the proceeds to a dependent in the form of equity or other elements of regulatory capital.
- Need to upgrade the legal framework of jurisdictions, allowing structures such as bankruptcy and restructuring laws, and capabilities of the accounting and audit profession.
- The bank would not be completely insulated from the capital burden of subsidiaries in intermediate holding companies principally organised on bank subsidiary model.

India-specific concerns

- An intermediate holding company with activities restricted to investment in group companies would not need registration under Section 45-I A of the RBI Act and would thus avoid the regulatory purview of the Department of Non-Banking Supervision of RBI.
- Using the intermediate holding company, the parent bank could avoid the present 20% limit on investment in financial services companies. If the former is unregulated, RBI foresees difficulty in obtaining crucial information from the intermediary holding company, as well as in enforcing prudent behaviour.
- Possibility of legal review where an insurance regulator gives a ruling permitting the intermediate holding company to increase indirect foreign holding above the prescribed limit.

Possible fallout from the discussion paper

Delay in creation of the holding companies

It is uncertain how long it would take for (a) RBI to prescribe final guidelines, (b) a proper legal framework, and (c) for the banks to re-draft their plans within this framework.

Re-assessment in valuation of unlisted subsidiaries

A part of the market value of some bank stocks arises from the estimated value of insurance subsidiaries. The latter had been re-rated in the past two quarters. This value could be re-assessed now with consequent impact on value of the parent banks, we believe.

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Disclosure appendix

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Issuer of report
HSBC Securities and Capital Markets (India) Private Limited
Registered Office
52/60 Mahatma Gandhi Road
Fort, Mumbai 400 001, India
Telephone: +91 22 2267 4921
Fax: +91 22 2263 1983
Website: www.hsbcnet.com/research