

NBFC crisis a wake-up call for RBI: Banks must now be ring-fenced from non-bank affiliates

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The corporate structure of banks must change to ringfence banks from their non-bank affiliates.



Rajendran pointed out that the real impact of the pandemic on the asset quality of the bank would only be known when the moratorium period was over.

- **NR Bhusnurmath**

In an innocuously worded press statement released early June, **RBI** announced the setting up of an Internal Working Group to ‘review existing guidelines on ownership and corporate structure for Indian private sector banks.’ Inevitably, the first part regarding, ‘ownership’ grabbed media attention, especially since the announcement followed quick on the heels of an earlier Discussion Paper on governance in commercial banks proposing limits on the term of promoter-CEOs in private banks.

Consequently, the latter, and perhaps, more material part of the announcement, ‘to study current regulations on holding of financial subsidiaries through non-operative financial holding company (NOFHC) and suggest the manner of migrating all banks to a uniform regulation in the matter, including providing a transition path’ escaped notice.

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Part of the reason could be that this is not the first time RBI is reviewing the corporate structure of banks. Soon after the global financial crisis, a committee headed by former Deputy Governor, Shyamala Gopinath, went into the issue and made some path-breaking recommendations. Only to have another expert group, headed by former Deputy Governor, Anand Sinha, return to the subject in 2013.

Despite that, very little has changed. Like a dog with a favourite bone, the corporate structure of banks is a subject that the RBI returns to the subject periodically; only to bury it! No one expects anything different this

time round. However, the crisis in the NBFC sector and the MF industry is a wake-up call to the regulator that it needs to look sharp. Unless it ring-fences the banking sector from mishaps in non-bank financial entities, the safety of the banking sector could itself be imperiled. With serious implications for financial and economic stability!

World over different countries follow different models. The dominant model in the US, following after the Gramm Leach Bliley Act (that repealed part of the 1933 Glass-Steagall Act), is the Financial Holding Company (FHC) model wherein banks and non-bank affiliates operate under the FHC.

This model has many advantages. Two, in particular, stand out. One, the FHC model is better at removing capital constraints and facilitating expansion in other financial services. The reason is simple. Under the FHC, subsidiaries are not directly held by the bank and hence the responsibility to infuse capital in the subsidiaries remains with the holding company, not the bank. Two, the direct impact of the losses of the subsidiaries would be borne by the holding company, unlike in the case of a bank holding company (BHC) model where it impacts the consolidated balance sheet of the bank.

A third advantage, but one that is currently less important in the Indian context, where banks are seldom liquidated, is that the FHC model allows for neater resolution of different entities compared with the BHC model where liquidation of the parent bank may make liquidation of subsidiaries inevitable. However, going forward this might become important as the government is thinking of bringing a resolution framework for financial institutions.

In India, non-bank activities have, historically, been undertaken by banks through a subsidiary route with the bank floating separate subsidiaries. As explained above, the problem with this structure is that the entire burden of corporate management of the group as well as future equity infusions needed for expansion of business and to meet regulatory capital requirements becomes the responsibility of the bank.

Further, the parent bank is directly exposed to the functioning of various subsidiaries. Any losses incurred by the subsidiaries inevitably impact the bank balance sheet. The banking regulator is also, perforce, compelled to monitor the health of all subsidiaries under the bank, even though each subsidiary might be under the jurisdiction of respective sectoral regulators.

Above all, there is the risk that the subsidy implicitly available to banks in the form of access to central bank liquidity, deposit insurance and access to payment systems gets transferred to non-bank affiliates giving rise to moral hazard (read, non-bank affiliates taking on excess risks secure in the knowledge they will be bailed out by the parent bank). We saw this happen in the case of the CanStar, an assured return scheme floated by Canbank Mutual Fund that had to be bailed out by its sponsor, [Canara Bank](#), in the 1990s.

Sadly, despite this experience RBI failed to move ahead to make the NOFHC model the norm for banks in India. In practice, however, it has been conscious of the spirit underlying the desired model. Hence, in 2007 it turned down [ICICI Bank](#)'s move to transfer its holding in non-banking companies to an intermediate holding company even though the Foreign Investment Promotion Board (FIPB) had cleared the bank's proposal to transfer its holdings in its insurance and asset management subsidiaries to an intermediate holding company. RBI put its foot down saying the intermediary holding company, being a non-banking finance company, would not be subject to the same regulatory rigour as in the case of banks.

The recent collapse of a number of NBFCs and MFs has once again brought home the dangers posed by an unholy and close connect between banks and their non-bank subsidiaries. Today, many of the large banks in India have significant holdings in a number of non-bank affiliates, exposing the parent banks to unwarranted risks.

The over-riding goal of financial stability is best served by ring-fencing banks and decreasing the probability of bank failure, given its systemic implications, by reducing both complexity and inter-connectedness. The Internal Working Group to 'review existing guidelines on ownership and corporate structure for Indian private sector banks' must make up for lost time and draw up a time frame for effecting the desired change in corporate structure.

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