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ECONOMIC FORUM

A monthly publication from South Indian Bank

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To empower the student community...

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Prompt Corrective Action by RBI

June 2017

Theme 307

PROMPT CORRECTIVE ACTION (PCA) BY RBI

26th Year of Publication

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SIB STUDENTS' ECONOMIC FORUM

JUNE 2017

Theme No: 307: Prompt Corrective Action (PCA) by RBI

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

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the "Forum". This month the topic for discussion is "Prompt Corrective Action (PCA)" by RBI.

1. What is PCA (Prompt Corrective Action)?

Prompt Corrective Action norms allow the regulator to place certain restrictions on banks such as halting branch expansion and stopping dividend payment. It can even cap a bank's lending limit to one entity or sector. Other corrective actions that can be imposed include special audit, restructuring operations and activation of recovery plan. Banks' promoters can be asked to bring in new management, too. The RBI can also supersede the bank's Board, under PCA.

2. Why the need for Prompt Corrective Action?

The loss incurring medium sized or large banks are rarely closed and the government tries to keep them afloat since the closure of these banks have an adverse impact on the economy. Bank rescues and mergers are far more common than outright closures. If banks are not to be allowed to fail, it is essential that corrective action is taken well ahead that the bank still has adequate cushion of capital to minimise the losses.

3. Who is covered under Prompt Corrective Action (PCA)?

The PCA framework will apply to all banks operating in India, including small finance banks and foreign banks operating through branches or subsidiaries. A bank will be placed under the PCA framework based on the audited annual financial results and the supervisory assessment made by RBI.

4. What does the RBI stipulate?

RBI has set trigger points on the basis of CRAR (Capital to Risk Asset Ratio), NPA (Non Performing Asset) and ROA (Return on Asset). Based on each trigger point, the banks have to follow a mandatory action plan. Apart from this, the RBI has discretionary action plans too. The rationale for classifying the rule-based action points into “mandatory” and “discretionary” is that some of the actions are essential to restore the financial health of banks while other actions will be taken at the discretion of RBI depending upon the profile of each bank.

5. Briefly explain the trigger point stipulated by RBI under the PCA framework?
Capital, Asset quality and Profitability is the key areas for monitoring as per the revised PCA framework. RBI has stipulated risk threshold for each parameter, which is given below:

i) Capital: Breach of any risk threshold on Capital, Asset quality and Profitability would trigger PCA. The Risk Threshold for CRAR and Common Equity Tier 1 is given below:

- CRAR – The Minimum regulatory prescription for capital to risk assets ratio plus the applicable capital conservation buffer (CCB) is 10.25% (9% minimum total capital plus 1.25% of CCB as on 31st March 2017)
    a) Risk Threshold 1 – Upto 250 bps below the minimum regulatory prescription i.e., less than 10.25% but more than or equal to 7.75%.
    b) Risk Threshold 2 – More than 250 bps but not exceeding 400 bps below the minimum regulatory prescription i.e., less than 7.75% but more than or equal to 6.25%.
- Common Equity Tier 1 – The regulatory pre-specified trigger of Common Equity Tier 1 plus applicable capital conservation buffer is 6.75% (5.5% plus 1.25% of CCB as on 31st March 2017)
    a) Risk Threshold 1 – Upto 162.50 bps below the regulatory specified Common Equity Tier 1 i.e., less than 6.75% but more than or equal to 5.125%.
    b) Risk Threshold 2 – More than 162.50 bps below but not exceeding 312.50 bps below the regulatory specified Common Equity Tier 1 i.e., less than 5.125% but more than or equal to 3.625%.
    c) Risk Threshold 3 – More than 312.50 bps below the regulatory specified Common Equity Tier 1 i.e., less than 3.625%.

ii) Asset Quality: It is measured in terms of Net Non-performing advances ratio (NNPA) i.e., the percentage of net NPAs to net advances

a) Risk Threshold 1 – The Net Non-performing advances ratio is more than or equal to 6% but less than 9%.
b) Risk Threshold 2 – The Net Non-performing advances ratio is more than or equal to 9% but less than 12%.
c) Risk Threshold 3 – The Net Non-performing advances ratio is more than or equal to 12%.

iii) Profitability: The indicator for profitability is Return on assets (ROA) i.e., the percentage of profit after tax to average total assets.

a) Risk Threshold 1 – Negative ROA for two consecutive years.

b) Risk Threshold 2 – Negative ROA for three consecutive years.
c) Risk Threshold 3 – Negative ROA for four consecutive years.

The above three parameters are key areas for monitoring and leverage is the additional parameter to be monitored as part of the PCA. The Leverage is measured in terms of Tier 1 capital, Tier 1 leverage ratio is less than or equal to 4% but equal to 3.5% is the Risk Threshold 1. The leverage is over 28.6 times the Tier 1 capital i.e., less than 3.5% is the Risk Threshold 2.

6. What are the types of restrictions put if PCA is triggered?
There are two types of restrictions, mandatory and discretionary.

I. Mandatory actions at different Risk Threshold

a) Risk Threshold 1
   i) Restriction on dividend distribution/remittance of profits.
   ii) Promoters in the case of foreign banks to bring in capital

b) Risk Threshold 2
In addition to mandatory actions of Threshold 1, the following restrictions are stipulated.
   i) Restriction on branch expansion, domestic and overseas.
   ii Higher provisions as part of the coverage regime.

c) Risk Threshold 3
In addition to mandatory actions of Threshold 1, Restriction on branch expansion domestic and overseas. Restriction on management compensation and directors' fees is also levied.

II. Discretionary actions which may be taken by the regulatory authority are given below:

a) Special Supervisory interactions
- Special Supervisory Monitoring Meetings (SSMMs) at quarterly or other identified frequency is organized, inspections/targeted scrutiny of the bank
- Special audit of the bank

b) Strategy related actions
The Bank's Board is advised by RBI on the following:
- Activate the Recovery Plan that has been duly approved by the supervisor
- A detailed review of business model in terms of sustainability of the business model, profitability of business lines and activities, medium and long term viability, balance sheet projections, short term strategy focusing on addressing immediate concerns, medium term business plans.
- To identify achievable targets and set concrete milestones for progress and achievement along with the scope for enhancement/ contraction in business lines.

- To undertake business process reengineering and restructuring of operations as appropriate.

c) Governance related actions

- RBI to recommend to owners to bring in new management / Board and it will impose restrictions on directors or management compensation as applicable.

d) Capital related actions

- To review capital planning and proposals for raising additional capital
- Restriction on investment in subsidiaries/associates, expansion of high risk-weighted assets to conserve capital and increasing stake in subsidiaries and other group companies.
- Bank to increase reserve through retained profits.
- Reduction in exposure to high risk sectors to conserve capital

e) Credit risk related actions

- Preparation of time bound plan and commitment for reduction of stock of NPAs and commitment for containing generation of fresh NPAs
- Strengthening of loan review mechanism
- Restrictions on/ reduction in credit expansion for borrowers below certain rating grades and unrated borrowers
- Reduction in risk assets, unsecured exposures and loan concentrations in identified sectors, Industries or borrowers.
- Action plan for recovery of assets / sale of assets through identification of areas and setting up of dedicated Recovery Task Forces and Adalats.

f) Market risk related actions

- Restrictions on/reduction in borrowings from the inter-bank market, accessing/ renewing wholesale deposits/ certificates of deposits.
- Restriction on excess maintenance of collateral held that could contractually be called any time by the counterparty.

g) HR related actions

- Restriction on staff expansion
- Review of specialized training needs of existing staff

h) Profitability related actions

- Restrictions on capital expenditure, other than for technological up gradation within Board approved limits.

i) Operations related actions

- Restrictions on branch expansion plans, domestic or overseas, entering into new lines of business, non-credit asset creation and undertaking specified businesses.
- Reduction in business at overseas branches/ subsidiaries/in other entities, risky assets and non-fund based business.

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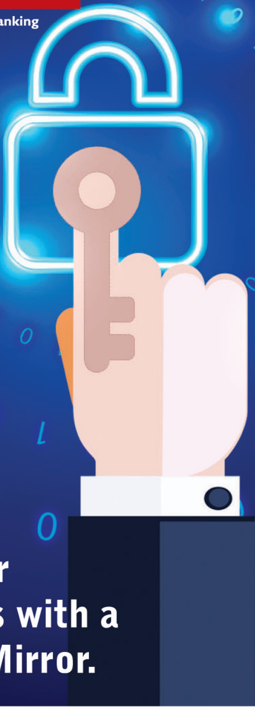

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