STUDENTS' ECONOMIC FORUM

A monthly publication from South Indian Bank

To kindle interest in economic affairs...
To empower the student community...

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Student's Corner

ho2099@sib.co.in

RBI'S REVISED PCA FRAMEWORK

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"Risk comes from not knowing what you are doing"

Warren Buffett

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is "RBI's Revised PCA Framework".

RBI has recently issued revised Prompt Corrective Action (PCA) Framework for Scheduled Commercial Banks which will be effective from January 1, 2022. The RBI introduced the PCA framework in 2002. The objective of the PCA Framework is to enable Supervisory intervention at appropriate time and require the Supervised Entity to initiate and implement remedial measures in a timely manner, so as to restore its financial health. The PCA Framework is also intended to act as a tool for effective market discipline. The framework was reviewed in 2017 based on the recommendations of the working group of the Financial Stability and Development Council on Resolution Regimes for Financial Institutions in India and the Financial Sector Legislative Reforms Commission. A bank will generally be placed under the PCA framework based on the audited annual financial results and the ongoing supervisory assessment made by the RBI.

Revised PCA Framework for Scheduled Commercial Banks

The PCA Framework does not preclude the Reserve Bank of India from taking any other action as it deems fit at any time, in addition to the corrective actions prescribed in the Framework. Key features of revised guidelines issued by RBI on PCA Framework are provided below,

A. Capital, Asset Quality and Leverage will be the key areas for monitoring in the revised framework. ('Leverage' replaced the earlier 'Profitability' criteria.)

B. Indicators to be tracked for Capital, Asset Quality and Leverage would be CRAR and/or Common Equity Tier I Ratio, Net NPA Ratio and Tier I Leverage Ratio respectively.

C. Breach of any risk threshold (as detailed under) may result in invocation of PCA by RBI.

D. Three risk thresholds are defined and actions specific to each risk thresholds are notified.

PCA matrix – Parameters, indicators and risk thresholds

Parameter	Indicator	Risk Threshold 1	Risk Threshold 2	Risk Threshold 3
(1)	(2)	(3)	(4)	(5)
Capital (Breach of either CRAR or CET 1 ratio)	CRAR - Minimum regulatory prescription for Capital to Risk Assets Ratio + applicable Capital Conservation Buffer (CCB)i.e. 9% + CCB of 2.5% - (Item A)	Upto 250 bps below the Indicator (Item A)	More than 250 bps but not exceeding 400 bps below the Indicator (Item A)	In excess of 400 bps below the Indicator (Item A)
	and/or			
	Regulatory Pre-Specified Trigger of Common Equity Tier 1 Ratio (CET 1 PST) + applicable Capital Conservation Buffer (CCB) i.e. 5.5% + CCB of 2.5% - (Item B)	Upto 162.50 bps below the Indicator (Item B)	More than 162.50 bps below but not exceeding 312.50 bps below the Indicator (Item B)	In excess of 312.50 bps below the Indicator (Item B)

Breach of either CRAR or CET 1 ratio to trigger PCA				
Asset Quality	Net Non-Performing Advances (NNPA) ratio	>=6.0% but <9.0%	>=9.0% but < 12.0%	>=12.0%
Leverage	Regulatory minimum Tier 1 Leverage Ratio.	Upto 50 bps below the regulatory minimum	More than 50 bps but not exceeding 100 bps below the regulatory minimum	More than 100 bps below the regulatory minimum
Leverage Ratio is the Ratio between Capital measure and Exposure measure. RBI stipulates Leverage Ratio of 4% for Domestic Systemically Important Banks (DSIBs) and 3.5% for other banks				

E. The PCA Framework would apply to all banks operating in India including foreign banks operating through branches or subsidiaries based on breach of risk thresholds of identified indicators.

F. RBI may impose PCA on any bank during the course of a year (including migration from one threshold to another) in case the circumstances so warrant.

G. Exit from PCA and Withdrawal of Restrictions under PCA - Once a bank is placed under PCA, taking the bank out of PCA Framework and/or withdrawal of restrictions imposed under the PCA Framework will be considered:

a) If no breaches in risk thresholds in any of the parameters are observed as per four continuous quarterly financial statements, one of which should be Audited Annual Financial Statement (subject to assessment by RBI); and

b) Based on Supervisory comfort of the RBI, including an assessment on sustainability of profitability of the bank.

H. When a bank is placed under PCA, one or more of the following corrective actions may be prescribed:

Mandatory and Discretionary actions		
Specifications	**Mandatory actions**	**Discretionary actions**
Risk Threshold 1	**Restriction on dividend distribution**/remittance of profits. Promoters/Owners/Parent (in the case of foreign banks) to bring in capital	Common menu Special Supervisory Actions Strategy related Governance related Capital related Credit risk related Market risk related HR related Profitability related Operations/Business related Any other
Risk Threshold 2	In addition to mandatory actions of Threshold 1, **Restriction on branch expansion;** domestic and/or overseas	
Risk Threshold 3	In addition to mandatory actions of Threshold 1 & 2, Appropriate **restrictions on capital expenditure,** other than for technological upgradation within Board approved limits	

PCA Framework for NBFCs

A month after it had come out with the revised prompt corrective action (PCA) framework for scheduled commercial banks, the Reserve Bank of India (RBI) issued a similar set of norms for non-banking finance companies (NBFCs) by introducing three risk threshold categories.The PCA framework for NBFCs will come into effect on October 1, 2022, based on their financial positions on or after March 31, 2022, the RBI said in a notification, adding that these will be reviewed after three years of being in operation.

The need to frame PCA norms for NBFCs was realized by RBI due to the growing size and complexity of NBFCs. The framework will apply to all deposit-taking NBFCs, excluding government companies, all non-deposit taking NBFCs in middle, upper and top layers, the RBI said.An NBFC will be placed under PCA framework on the basis of the audited annual financial results or on the basis of the supervisory assessment made by the banking regulator.However, the RBI may impose PCA on any NBFC during the course of a year (including migration from one threshold to another) in case the circumstances so warrant, it added. Breach of any risk threshold (as detailed under) may result in invocation of PCA and the Reserve Bank may issue a press release when a NBFC is placed under PCA as well as when PCA is withdrawn vis-à-vis a NBFC.

For NBFCs-D and NBFCs-ND (excluding CICs):

Mandatory and Discretionary actions			
Indicator	**Risk Threshold-1**	**Risk Threshold-2**	**Risk Threshold-3**
CRAR	Upto 300 bps below the regulatory minimum CRAR [currently, CRAR <15% but ⩾12%]	More than 300 bps but upto 600 bps below regulatory minimum CRAR [currently, CRAR <12% but ⩾9%]	More than 600 bps below regulatory minimum CRAR [currently, CRAR <9%]
Tier I Capital Ratio	Upto 200 bps below the regulatory minimum Tier I Capital Ratio [currently, Tier I Capital Ratio <10% but ⩾8%]	More than 200 bps but upto 400 bps below the regulatory minimum Tier I Capital Ratio [currently, Tier I Capital Ratio <8% but ⩾6%]	More than 400 bps below the regulatory minimum Tier I Capital Ratio [currently, Tier I Capital Ratio <6%]
NNPA Ratio (including NPIs)	>6% but ⩽ 9%	>9% but ⩽12%	>12%

For CICs (Core Investment Companies):

Mandatory and Discretionary actions			
Indicator	**Risk Threshold-1**	**Risk Threshold-2**	**Risk Threshold-3**
Adjusted Net Worth / Aggregate Risk Weighted Assets	Upto 600 bps below the regulatory minimum ANW/RWA [currently, ANW/RWA <30% but ⩾24%]	More than 600 bps but upto 1200bps below regulatory minimum ANW/RWA [currently, ANW/RWA <24% but ⩾18%]	More than 1200 bps below regulatory minimum ANW/RWA [currently, ANW/RWA <18%]
Leverage Ratio	⩾2.5 times but <3 times	⩾ 3 times but <3.5 times	⩾3.5 times
NNPA Ratio (including NPIs)	>6% but ⩽ 9%	>9% but ⩽12%	>12%

Bringing a NBFC out of PCA can be considered if no breaches in risk thresholds in any of the parameters are observed during four continuous quarterly financial statements, one of which should be annual audited financial statement (subject to assessment by RBI) and on the basis of the supervisory comfort of the central bank, if it sees sustained profitability in the institution.

The menu of corrective actions is as below:

<table>
<tr><th colspan="3">Mandatory and Discretionary actions</th></tr>
<tr><th>Specifications</th><th>Mandatory actions</th><th>Discretionary actions</th></tr>
<tr><td>Risk Threshold 1</td><td>Restriction on dividend distribution/remittance of profits;
Promoters/shareholders to infuse equity and reduction in leverage;
Restriction on issue of guarantees or taking on other contingent liabilities on behalf of group companies (only for CICs)</td><td rowspan="3"><u>Common menu</u>
Special Supervisory Actions
Strategy related
Governance related
Capital related
Credit risk related
Market risk related
HR related
Profitability related
Operations/Business related
Any other</td></tr>
<tr><td>Risk Threshold 2</td><td>In addition to mandatory actions of Threshold 1,
Restriction on branch expansion</td></tr>
<tr><td>Risk Threshold 3</td><td>In addition to mandatory actions of Threshold 1 & 2,
Appropriate restrictions on capital expenditure, other than for technological upgradation within Board approved limits
Restrictions/reduction in variable operating costs</td></tr>
</table>

Additional Information:

Non-Performing Asset:

It is a loan or advance for which the principal or interest payment remains overdue for a period of 90 days.Banks are required to classify NPAs further into Substandard, Doubtful and Loss assets.

Capital Adequacy Ratio (CAR):

The CAR is a measure of a bank's available capital expressed as a percentage of a bank's risk-weighted credit exposures.The Capital Adequacy Ratio, also known as capital-to-risk weighted assets ratio (CRAR), is used to protect depositors and promote the stability and efficiency of financial systems around the world.

Tier 1 Leverage Ratio:

It is the relationship between a banking organization's core capital and its total assets.The tier 1 leverage ratio is calculated by dividing tier 1 capital by a bank's average total consolidated assets and certain off-balance sheet exposures.A leverage ratio is any one of several financial measurements that assesses the ability of a company to meet its financial obligations.Some of the examples are:

a) **Equity Ratio:** This ratio indicates total owner contribution in the company.
b) **Debt Ratio:** This ratio indicates total leverage used in the company.
c) **Debt to Equity Ratio:** This ratio indicates total debt used in the business in comparison to equity.

Source:

a) https://www.rbi.org.in
b) https://business-standard.com
c) https://thehindu.com
d) https://drishtiias.com

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