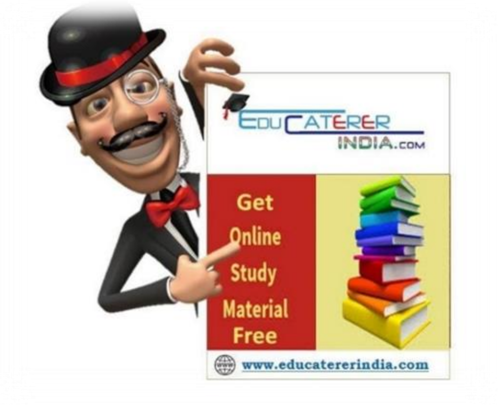
UNIT 12 - Prompt Corrective Action of RBI- Recent Updates



Introduction

Reserve Bank of India (RBI) has issued a policy action (first in May 2014 and revised effective from April 1, 2017) in the form of prompt corrective action (PCA) framework. When a bank have low capital adequacy or high Non- performing assets, which are specified as trigger point; in such case, RBI takes a corrective action.

Need of PCA

In the 1980s and early 1990s, it was a period of great depression for the banks and financial institutions all over the globe. In the USA, more than 1600 commercial banks which are covered by Federal Deposit Insurance Corporation (FDIC) were either closed or given financial assistance during this period. The losses which were incurred by the banks and financial institutions were more than $100 billion so, to avoid these tremendous bank failures which have a bad impact on the economy it led to the search for suitable strategies and one of them is PCA.

Implemented

The provisions of the revised PCA framework effective from 1st April 2017 based on the financials of the banks for the year ended 31st March 2017. The PCA framework would be reviewed after 3 years.

RBI specification on PCA

RBI has set trigger points based on CRAR, NPA and ROA. Based on each trigger points RBI has made a binding plan which is to be followed by the banks. RBI has classified the rules into two parts Binding and Discretionary. Binding in which actions are mandatory to be taken by banks and discretionary in which RBI decides actions by seeing the profile of each bank.

CRAR: CRAR is capital to risk-weighted assets ratio. It is a measure of bank's capital and defined as a percentage of a bank's risk-weighted credit exposures. This ratio is used to protect depositors and promote efficiency and stability in financial system. There are basically two types of capital:

- Tier I capital: It helps in absorbing losses without affecting the bank's capital.
- Tier II capital: It is used to absorb losses while winding up of the business.

NPA: In a layman language NPA is the amount of loan that was not returned by the customer and when it stops generating income for the bank those assets become NPA. As per the RBI norms, if a loan is overdue during the last 90 days it will be categorized as NPA. Overdue is a situation in which loan is not paid by the due date which is fixed by the bank.

ROA: Return on Assets is a financial ratio that shows the percentage of profit that company earns in relation to its overall resources. It defines how profitable a company's assets are in generating revenue.

ROA= Net Income/Average Total Assets

Trigger Points:

CRAR

- CRAR less than 9% but equal or more than 6%
- CRAR less than 6% but equal or more than 3%
- CRAR less than 3%

NPAs

- Net NPAs over 10% but less than 15%
- Net NPAs 15% and above

ROA

- ROA below 0.25%

The salient feature of revised PCA framework for Banks:

- For monitoring in the revised framework, the key areas are capital, asset quality and profitability.
- The indicator, which tracked the key areas, would be CRAR/ common equity Tier 1 ratio, net NPA ratio and return on assets.
- Leverage would be monitored.
- It applied for all banks including small banks and foreign banks operating in India.
- PCA framework also based on the audited annual financial results and the supervisory Assessment made by RBI. The PCA is invoked when risk threshold such as capital, asset quality and profitability are breached.

Bank's Step after PCA Triggered

- Banks are not allowed to renew or access costly deposits and they are not allowed to enter new line of business.
- RBI will also impose restrictions on the bank on borrowings from interbank market.
- Bank will also have to take steps to reduce the stock of NPA.

Banks under PCA

United Bank of India

PCA Triggered on: 20 December 2017

Net Loss of Bank: 344.83 crore for the second quarter ended September 30 against a net profit of Rs 43.53 crore for the corresponding period a year ago

Corporation Bank

PCA Triggered on: 13 December 2017

Net Loss: Rs 1,035 crore in the second quarter of Fiscal year

In the past, RBI has placed restrictions on seven banks which include Oriental Bank of Commerce, Dena Bank, Central Bank of India, IDBI Bank, Indian Overseas Bank, Bank of Maharashtra and UCO Bank. The RBI has also clarified in the past that banks are placed under PCA to facilitate them to take corrective measures to restore their financial health.

Strategy Related Action:

- Activate the Recovery plan
- Undertake a detailed review of the business model in terms of sustainability, profitability, viability and projections.
- Review medium-term business plan, the scope for enhancement.
- Identify the targets and set a milestone for progress and achievements. Two banks where PCA invoked were IDBI Bank and UCO Bank both the banks breached risk threshold 2.