PCA framework for NBFCs

Why in news?

The Reserve Bank of India (RBI) has decided to put in place a prompt corrective action (PCA) framework for troubled non-banking finance companies to restore their financial health.

What is Prompt Corrective Action (PCA)?

- **History -** RBI initiated the Scheme of Prompt Corrective Action (PCA) in 2002.
- In early 2018, there were 12 banks under PCA framework. Of these, 11 were PSBs.
- Due to recapitalization & corrective measures there were only six banks (all PSBs) under the PCA framework as of March 2019.
- **Objective -** Prompt Corrective Action or PCA is a framework under which financial institutions with weak financial metrics are put under watch by the RBI.
- Until now, the RBI had imposed PCA only on banks. This is the first time PCA framework is extended to NBFCs.
- The move comes in the wake of large NBFCs such as IL&FS, DHFL, SREI Group and Reliance Capital getting into financial trouble over the last few years.
- **Applicability -** The PCA framework for NBFCs comes into effect from October 1, 2022, based on their financial position on or after March 31, 2022.
- The framework will apply to all deposit-taking NBFCs, excluding government companies, and all non-deposit taking NBFCs in the middle, upper and top layers.
- **Implications -** This is a welcome move as it will stop bad lenders from going worse rather than brushing the issue aside.
- Safer NBFCs will translate to a safer overall financial system.
- The PCA framework for NBFCs will be reviewed after 3 years.

What are the tracking indicators?

- The central bank will track three indicators
    - Capital To Risk-Weighted Assets Ratio (CRAR) - It is bank's available capital expressed as a percentage of a bank's risk-weighted credit exposures.
    - Tier I leverage ratio - It is the relationship between a banking organization's core capital and its total assets.
    - Net Non-Performing Assets (NNPAS) Including Non-Performing Investments (NPIS). NPA are loans for which the principal or interest payment remained overdue for a period of over 90 days
- In the case of core investment companies (CICs), the RBI will track
    - Adjusted Net Worth/Aggregate Risk Weighted Assets.
    - Leverage Ratio
    - NNPAs, including NPIs.
- A breach in any of the three risk thresholds under the above mentioned indicators could result in invocation of PCA.

What is the Threshold limit?

- **Threshold limit 1**
  - If CRAR fall more than 300 basis points below the minimum required 15% (for both deposit or non deposit taking NBFCs)
  - Tier 1 capital ratio drops 200 basis points below the minimum required 8%
  - NNPA ratio increases above 6%.
- **Threshold limit 2**
  - If capital adequacy falls a further 300 basis points,
  - Tier 1 capital ratio drops another 200 basis points below the minimum required
  - NNPA rises above 9%.
- **Threshold limit 3**
  - Fall in capital adequacy to less than 9%
  - Tier 1 capital to less than 6%
  - NNPA rises above 12%.

What Corrective Actions will be taken under PCA?

- There are 2 types of Corrective Actions.
  - **Mandatory Corrective Actions**
  - **Discretionary Corrective Actions**
- Based on the risk threshold, the RBI may prescribe discretionary corrective actions in addition to mandatory corrective actions.

Mandatory Corrective Actions under PCA are as follows.

- **For Threshold limit 1 -** There will be restriction on
  - Dividend distribution/remittance of profits,
  - Requiring promoters/shareholders to infuse equity and reduce leverage,
  - Restriction on issue of guarantees or taking on other contingent liabilities on behalf of group companies (only for CICs).
- **For Threshold limit 2 -** In addition to restrictions under condition 1, the RBI may
  - Restrict branch expansion.
- **For Threshold limit 3 -** In addition to restrictions under condition 1 & 2, the RBI may
  - Impose curbs on capital expenditure other than for technological upgradation.
  - Restrict/ directly reduce variable operating costs.

Discretionary Corrective Actions - Under this, the RBI may

- Undertake resolution of NBFC by **amalgamation, reconstruction, splitting**.
- File an insolvency application under the IBC and issue show-cause notice for cancellation of certificate of registration and winding up of the NBFC.
- Recommend to promoters/shareholders to bring in new management/board;
- Remove managerial persons under the RBI Act, as applicable;
- Seek removal of director and/or appointment of another person as director in his place;
- Supersede the board under the RBI Act and appoint an administrator among others.
- PCA restrictions will be withdrawn if there is no breaches in risk thresholds in any of the parameters are observed as per four continuous quarterly financial statements
- However, one of statements should be annual audited financial statement (subject to assessment by RBI) after a RBI led supervision.

What will be the implications?

- The thresholds around total capital adequacy and Tier-I capital for classification of an NBFC in the PCA category are liberal
- However some entities could breach the net NPA criterion of more than 6%, if the asset quality does not improve.
- Once PCA guidelines are applicable entities are expected to bring the NPA levels under control by improving provisions or effecting write-offs.
- However the sectoral growth will be impacted in the near term, as entities tighten their credit norms and operational focus shifts towards collections.

Quick Facts

- **NPA - Nonperforming assets (NPAs)** are recorded on a bank's balance sheet after a prolonged period of non-payment by the borrower.
- NPAs place financial burden on the lender.
- NPAs can be classified as a substandard asset, doubtful asset, or loss asset, depending on the length of time overdue and probability of repayment.
- Lenders have options to recover their losses, including taking possession of any collateral or selling off the loan at a significant discount to a collection agency.
- If no assets were pledged, the lender might write-off the asset as a bad debt and then sells it at a discount to a collection agency.
- **Capital Adequacy Ratio –** It is also known as capital-to-risk weighted assets ratio (CRAR). It is used to protect depositors and promote the stability and efficiency of financial systems.
- CAR is a measurement of a bank's available capital expressed as a percentage of a bank's risk-weighted credit exposures.
- Two types of capital are measured.
    - **Tier-1 Capital,** which can absorb losses without a bank being required to cease trading.
    - **Tier-2 Capital,** which can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.
- The downside of using CAR is that it doesn't account what would happen in a financial crisis.
- **The tier 1 leverage ratio –** It is the relationship between a banking organization's core capital and its total assets.
- It is calculated by dividing tier 1 capital by a bank's average total consolidated assets and certain off-balance sheet exposures.
- A bank with a high capital adequacy ratio is considered to be above the minimum requirements needed to suggest solvency.

Reference

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