Significance of Prompt Corrective Action

Why in news?

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In India there is a public debate regarding relaxation of the Prompt Corrective Action (PCA) norms imposed on 11 public sector banks (PSBs).

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What is PCA?

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- The PCA is triggered when banks breach certain regulatory requirements like minimum capital, return on asset and quantum of non-performing assets.
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- To ensure that banks don't go bust, RBI has put in place some trigger points to assess, monitor, control and take corrective actions on banks which are weak and troubled.
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- The process or mechanism under which such actions are taken is known as Prompt Corrective Action, or PCA.
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What is the PCA plan of USA?

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- The PCA framework is employed internationally by regulators as a form of structured early-intervention and resolution mechanism, designed to help banks regain health by preserving capital.
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- The 1980s and early 1990s were a period of great stress and turmoil for banks and financial in situations all over the globe.
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- In USA, more than 1,600 commercial and savings banks in sued by the

Federal Deposit Insurance Corporation (FDIC) were either closed or given financial assistance during this period.
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- The cumulative losses incurred by the failed institutions exceeded US $100 billion.
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- These events led to the search for appropriate supervisory strategies to avoid bank failures as they can have a destabilizing effect on the economy.
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How RBI’s PCA differs from USA?

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- In the US, the PCA framework is based more on constrained discretion rules that are applied contextually.
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- The PCA framework in India is more rule-based and hence more stringent.
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- Regulators can be expected to employ their discretion advantageously when there is an opportunity for "learning by doing".
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- Perhaps the US PCA framework encompasses more learning by doing and hence is less stringent.
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- As far as provisioning is concerned, Indian banks are subjected to gradual age-wise provision for substandard assets starting from 15 per cent in the first year to 100 per cent in the fourth year, irrespective of whether collateral is available or not.
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- In the US, provisioning norms are purely discretion-based and are provided for by banks as per estimated credit losses associated with the loan portfolio.
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- In case of a commercial loan, the fair value of the collateral is taken into consideration to account for provisioning, if any.
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- For a mortgage loan, only on 270 days delinquent, all mortgages are placed on non-accrual status only if the realizable value of the collateral is inadequate in servicing the loan value. In fact, if a mortgage loan is fully insured, it is not even placed on non-accrual status even after 90 days.
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- While the FDIC triggers the PCA, based on bank capital threshold and leverage, the RBI’s PCA thresholds also include asset quality and profitability.
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What is the significance of RBI’s PCA?

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- RBI has set trigger points on the basis of CRAR (a metric to measure balance sheet strength), NPA and ROA.
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- Based on each trigger point, the banks have to follow a mandatory action plan.
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- 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.
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- Banks are not allowed to re new or access costly deposits or take steps to increase their fee-based income.
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- Banks will also have to launch a special drive to reduce the stock of NPAs and contain generation of fresh NPAs.
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- They will also not be allowed to enter into new lines of business, RBI will also impose restrictions on the bank on borrowings from interbank market.
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Source: Business Standard

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