Prompt Corrective Action

[UPSC Notes]

What is Prompt Corrective Action?

With the use of Prompt Corrective Action, the Reserve Bank of India keeps track of the banks with poor financial performance.

- The objective of PCA is to address the issues of the non-performing assets in the banking system of India.
- Prompt Corrective Action needs to inform the depositors and investors when a bank is in crisis.
- The goal of PCA is to prevent the problems from reaching crisis proportions.
- Most importantly, the Prompt Corrective Action assists RBI to monitor the bank's key performance indicators, and take corrective actions that would help in restoring the bank's financial stability.
- PCA frameworks for Non-Banking Financial Companies comes(NBFCs) will come into effect on October 1, 2022, based on their financial position on or after March 31.

History of Prompt Corrective Action

- The Reserve Bank of India (RBI) introduced the PCA framework in 2002.
- The Prompt Corrective Action was reviewed in 2017, based on the recommendations of the Financial Sector Legislative Reforms Commission, and a working group of the Financial Stability and Development Council on Resolution Regimes for Financial Institutions in India
- In early 2018, there were 12 banks under this framework, and among these 11 were Public sector banks.
- As of March, there were only six banks under the PCA framework, due to corrective measures, and recapitalization and all six are PCBs.

Applicability of Prompt Corrective Action

- The Prompt Corrective Action applies to all the banks operating in India. It also includes the foreign banks operating through subsidiaries or branches on breach of risk thresholds of the identified indicators.
- However, the Small Finance Banks and Payment Banks have been removed from the list of lenders where PCA can be initiated.

Parameters used in the Prompt Corrective Action Framework

Parameters used in the PCA are given below.

- Capital Adequacy Ratio (CAR)- is used to boost the financial system's stability and protect depositors around the world.
- CET-1 Ratio- it is the percentage of common equity capital, net of regulatory adjustments, to total risk-weighted assets as defined in RBI Basel III guidelines.
- Non-Performing Asset- it’s a loan where the interest payment is past due for more than 90 days.
- Tier 1 Leverage Ratio- is the link between a core capital of a bank and total assets.

How Prompt Corrective Action Framework works?

The Prompt Corrective Action Framework allows a regulator to place certain restrictions. It can be stopping the payment, or increasing the branches in the country or overseas. It also allows placing a cap on the lending limit of a bank to one sector.

Apart from that, some corrective measures are taken such as:

- Restructuring operations
- Special audits
- Bringing new management
- Superseding the bank's board of directors

A PCA framework is evoked when certain limitations placed on banks are exceeded. These limitations are based on the levels of capital and assent qualify profitability. When the number of negative returns on assents runs into 4 consecutive years, the restriction is applied.

Actions Taken by RBI under Prompt Corrective Action

We have divided the actions taken by RBI under the PCA framework into three Risk Threshold 1, Risk Threshold 2, and Risk Threshold 3.

Risk Threshold 1

- Here the dividend distribution and remittance of profits will be restricted.
- The owners, promoters, and parent (for the foreign banks) need to bring capital.

Risk Threshold 2

- Here in actions of Risk Threshold, 1 will be added.
- Restriction of the branch expansion will be applied whether it is overseas or domestic

Risk Threshold 3

- Here the actions of Risk Thresholds 1 and 2 will be added.
- The restriction will be on the capital expenditure, apart from the technological up-gradation will be approved within the board limits.

Types of Restrictions Placed under Prompt Corrective Action

There are mainly two types of restrictions under the Prompt Corrective Action

- Mandatory Restriction- the restrictions on the extension of the branch, dividend, and directors' compensation fall under mandatory restrictions.
- Discretionary Restriction- restrictions on deposits and lending are under this restriction.

Significance of Prompt Corrective Action

Some of the positive impacts of Prompt Corrective Action are the following:

- The operational performance of Private sector banks has improved in April-June 2018 quarter. Reduction in the net losses, improvement in provision coverage ratio, and increase in recoveries can be seen as well.
- The government is providing adequate capital for Prompt Corrective Action when required.
- Prompt Corrective Action helps the Reserve Bank of India to monitor the performance indicators of the banks, and take calculative measures to restore the financial stability of the bank.
- PCA helps to alert the depositors, investors, and regulators if a bank is heading towards trouble.

Issues with Prompt Corrective Action

The concerns with the Prompt Corrective Action framework are noted down below.

- It has a bad impact on the rating of a bank, and consumer confidence. In long run, it points out concerns about the bank’s management and affects the bank’s credit history.
- PCA may boost the loss of market share and also decline the position of the Public sector bank, in favor of the Private banks and foreign banks.
- according to the government, Prompt Corrective Action is a barrier to economic growth. That’s why the government is advocating friendlier lending regulations.
- The not-so-friendly situation between the RBI and the government may impact India’s reputation as an investment destination.