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RBI's Revised PCA Framework for Ailing Banks

Ms. Inchara P. M Gowda
Research Scholar,Institute of Management Studies,Kuvempu University,
JnanaSahyadri, Shankaraghatta 577 451(Karnataka)

Dr. K. R. Manjunatha
Assistant Professor, Institute of Management Studies, Kuvempu University,
JnanaSahyadri, Shankaraghatta 577 451(Karnataka)

Abstract

Banking and financial institutions in the country play multiple and pivotal roles, and contribute substantiallyfor the overall development of the economy. In spite of this pivotal role that these banking institutions are playing, their financial performance is not satisfactory. One of the indicators of this not-so satisfactory performance is the mounting non-performing loans (NPLs). This is adversely affecting their performance from the points of view of other indicators such as capital adequacy, return on assets, etc. This NPL has, therefore, become a big challenge for the bankers and also to the government. To resolve this problem of mounting NPLs of banks, the Reserve Bank of India (RBI) and the Government of India (GOI) have taken many a number of steps. However, these measures have not yielded the desired result and the problem remain unresolved. Hence, the apex bank of the country revised its earlier scheme viz., Prompt Corrective Action (PCA) Framework of 2002 thoroughly and issued the Revised PCA Framework in April 2017 identifying the key performance areas, parameters to measure the performance of banks in each of these key areas, Risk Thresholds for each performance indicator and also the corrective actions required to be taken by the banks if their performance breach the Risk Thresholds. In this background, this paper makes an attempt examine the problem together with other related issues followed by an analysis of different aspects of Revised PCA Framework, 2017.

Key Words/Terms: Asset Quality, CAR, CET - 1 Ratio, CRAR, Net NPA Ratio, Prompt Corrective Action, Return on Assets Ratio, Risk Thresholds, Tier - I and II Capital

Introduction

Banking and financial institutions play a stupendous role in the overall development of the economy. This is true even in the case of Indian banking and financial institutions. They provide profitable and secured avenues for the general public to park their surplus fund, and also provide loans and advances to those who are in need of fund including the economic entities. On the public deposits, the banking and financial institutions pay interest at the agreed rate periodically which is inescapable. On the other hand, on the loans and advances, they earn interest income which is, in some cases, uncertain. Besides uncertain interest income, there is also an uncertainty about receiving back the amount lent in accordance with the payment schedule. This uncertainty with regard to both the interest income and the receipt of principal loan amount is leading to a number of problems to the lending bankers. These problems are leading to deterioration in the asset quality, curtailment of fund for further lending, reduction in the Capital Adequacy Ratio, decline in the interest income, reduction in the spread, reduction in the rate of return on assets, etc. All these problems, in one way or the other, are centered around non-performing loans/assets (NPLs/NPAs) and this NPA has become a very big challenge not only to banking organizations in the country but

also for the higher authorities including the apex bank and the government.

NPAs - A Few Statistics

Public sector banks (PSBs) in India are struggling hard with NPAs/bad loans amounting to little over ₹ 6 lakh crore. Bad loans increased by over ₹ 1 lakh crore in the first nine months of the last fiscal to ₹ 6.07 lakh crore by 31 December 2016. The gross NPAs of these banks stood at ₹ 5.02 lakh croreas at 31 March 2016 and at ₹ 2.67 lakh crore at the end of 2014-15 financial year.Further, the NPAs of banks have increased to ₹ 6.15 lakh crore by the end of February 2017.A few more relevant statistics pertaining to the NPAs of Indian banks are presented in the following graph (Figure - 1).

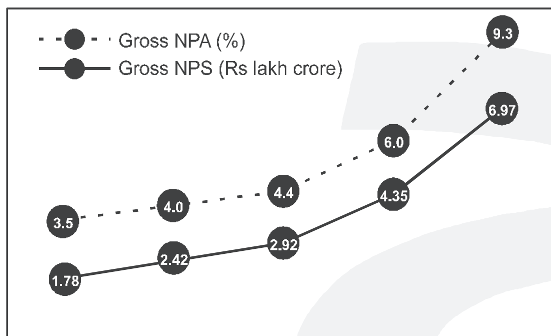

Figure -1 Gross NPA

It is obvious from the above that both the amount and the ratio of Gross NPA of Indian banks have been increasing year after year continuously which should be a matter of great concern for all stakeholders. A recent annual report of the United Nations Economic and Social Commission for Asia and Pacific observes that the country (i.e., India) faced immense risks from concentration of bad loans in PSBs. This is another indication of the gravity of the problem.The core problem of NPAs is with a very few large corporate borrowers (predominantly in infrastructure, power, steel and textile sectors).These corporate giants borrowed huge sums from the banks to expand their capacity during the boom period, 2003-08, but failed to face the onslaught of global financial crisis. As a result, there has been a slow-down in the operations of these corporate-borrowers leading to default in their payment schedule to lending banks.These corporate defaults are resulting in mounting NPAs of banks. As stated by Sri ChaudharyBirendra, the Minister of Steel, in the LokSabha recently, Indian Steel Sector owes about ₹ 3 lakh crore to banks. Further, as Sri Arun Jaitley, the Finance Minister, said in the Lok Sabha recently, top 20 NPAs account for ₹ 1.54 lakh crore. According to the Financial Stability Report (December 2016)of the Reserve Bank of India (RBI, apex bank), the large borrowers (i.e., the debtors to whom the lenders have an exposure of at least ₹ 5 crore each) account for 56 per cent of banks' debt but 88 per cent of their NPAs! It is, therefore, expected that if the banks recover the amounts due from their 40 - 50 large corporate borrowers, it would reduce the banks' NPAs substantially and this will be a great relief not only to the banks but also for the country's economy. However, all these statistics clearly demonstrate the severity of NPA problem of banks including PSBs and SCBs (Scheduled Commercial Banks).

To address this mounting and challenging NPA problem of banks, both the Government of India (GOI) and the RBI have taken many a number of steps/actions in the form of issue of guidelines and directivesto the banks, formulation of schemes, etc. And the recent one is the issue of Revised Prompt Corrective Action Framework (Revised PCA Framework) for banks by the RBI on 13 April 2017. In this background, this paper makes an endeavour to examine different dimensions of the Revised PCA Framework issued by the RBI.

Conceptual Framework

The Revised PCA Framework uses certain terms and parameters whose meanings are specific and not similar to those used in rest of the corporate world. Hence, an attempt is made here to present four important indicators/concepts in the right perspective before taking up the RBI's Revised PCA Framework for analysis.

The financial performance of any bank depends, to a greater extent, on its performance in at least four important key areas viz., capital adequacy, asset quality, profitability, and leverage. The performance of a bank with regard to each of these key areas is measures and indicated by CRAR/Common Equity Tier - I Ratio, Net NPA Ratio, Return on Assets (RoA) Ratio, and Tier - 1 Leverage Ratio respectively.

One of the four key areas is the Capital Adequacy and this is measured by CRAR/Common Equity Tier - 1 Ratio. CRAR is the acronym for the Capital to Risk Weighted AssetsRatio or Capital Adequacy Ratio (CAR) which considers both Tier - I and Tier - II capital. On the other hand, the Common Equity Tier - 1 Ratio (CET - 1 Ratio) is a part of CRAR as it (CET - 1 Ratio) represents the percentage of Core Equity Capital (net of Regulatory Adjustments) to Total Risk Weighted Assets. However, on the basis of the degree of contribution to capital from the owners (i.e., shareholders), capital is classified into two broad categories as Tier - I Capital and Tier - II Capital.

1) **Tier - I Capital,** as specified by the RBI,refers to one of the components of regulatory capital comprising share capital and disclosed reserves (less, goodwill, if any). And the major portion of Tier - I Capital (also called, **Core Capital**) is, usually, in the form of equity capital. Therefore, the items of Tier - I Capital are deemed to be of highest quality as they are available fully to cover losses. Anyhow, Tier - I Capital is equivalent to the aggregate of (i) Common Equity Tier - I and (ii) Additional Tier - I.

2) **Tier - II Capital,** also known as **supplementary capital**, refers to one of the components of regulatory capital (i.e., qualifying as regulatory capital to the extent that they can be used to absorb losses arising from the activities of banks). However, the loss absorption capacity of Tier - II Capital is lower than that of Tier - I Capital as it is more in the form of reserves, debts, etc. However, it comprises certain reserves and certain types of **subordinated debt**[i.e.,the debt which has only a secondary claim on repayments (after other debts have been repaid) in the event of bankruptcy/liquidation of the debtor].

3) **Risk-Weighted Asset** represents the product of notional amount of the asset (i.e., mostly, loans) and risk assigned to that asset. It may be noted here that the **'risk weight'** differs from one asset to another e.g., risk weight assigned to (i) each of cash in hand and balance with the RBI is '0' (zero), (ii) balances in current accounts of other banks is 0.2 (i.e., 20%), (iii)loans granted to public sector undertakings (PSUs) of either GOI or state governments is '1' (i.e., 100 per cent), (iv) investments in venture capital funds is 1.5 (i.e., 150%), etc. These weights are determined and assigned in accordance with the Basel Committee guidance for assets of each credit rating slab.

Using the above variables, CAR/CRAR is computed by dividing the capital of the bank by the aggregated risk weighted assets for credit risk, market risk and operational risk as follows.

$$\left.\begin{matrix}\text{CAR or}\\ \text{CRAR}\end{matrix}\right] = \left[\frac{\text{Tier - I Capital + Tier - II Capital}}{\text{Risk Weighted Assets or Exposures}} \times 100\right]$$

This Ratio measures the capital adequacy in terms of riskiness of the loans/assets. The apex bodies specify the minimum amount of capital a bank has to hold given the size of its risk-weighted assets. For example, if the CRAR is specified at 9 per cent, then the bank has to back every ₹ 100 of commercial loans with ₹ 9 of capital.Therefore, 'higher the loan assets, higher should be the capital of the bank'. This also means that 'higher the CRAR of a bank, the better capitalized it is'.Further, the Revised PCA Framework requires the Capital Conservation Buffer (CCB) i.e., building up of capital buffers by the banking institutions outside periods of stress which can be drawn down as losses are incurred.

The second key area is the asset quality and it is reflectedby the Net NPA Ratio. This Ratio (also called, Net Non-performing Advances Ratio) is computed by dividing the amount of Net NPA by

the amount of Net Advances and usually, it is expressed in terms of percentage as presented below.

$$\text{Net NPA Ratio} = \left[\frac{\text{Amount of Net NPA}}{\text{Amount of Net Advances}} \times 100\right]$$

Therefore, two variables viz., the amount of Net NPA and the amount of Net Advances need some description. When an asset, including a leased asset, ceases to generate income for the bank, it is reckoned as gross non-performing asset (Gross NPA).On the other hand, Net NPA represents the excess of Gross NPA over the aggregate of (i) total provisions held, (ii) part payment received and kept in suspense account, (iii) balance in Interest Suspense Account, and (iv) DICGC (Deposit Insurance and Credit Guarantee Corporation)/ECGC (Export Credit Guarantee Corporation) claims received and held pending adjustment. That means,

$$\left[\begin{matrix}\text{Net Non-}\\\text{performing}\\\text{Asset}\end{matrix}\right] = \left[\begin{matrix}\text{Gross}\\\text{Non-}\\\text{performing}\\\text{Asset}\end{matrix}\right] - \left[\begin{matrix}\text{Total}\\\text{Provi-}\\\text{sions}\\\text{Held}\end{matrix} + \begin{matrix}\text{Total}\\\text{Payment in}\\\text{Suspense}\\\text{Account}\end{matrix} + \begin{matrix}\text{Balance in}\\\text{Interest}\\\text{Suspense}\\\text{Account}\end{matrix} + \begin{matrix}\text{DICGA/ECGC}\\\text{Claims Received}\\\text{but pending}\\\text{Adjustment}\end{matrix}\right]$$

On the other hand, the amount of **Net Advances** represents the difference between the gross advances and repayments of principal received as presented below.

$$\left[\text{Net Advances}\right] = \left[\text{Gross Advances}\right] - \left[\text{Repayments of Principal}\right]$$

The third key area is the profitability and it is indicated by, among others, **Return on Assets Ratio.** This Ratio establishes the meaningful relationship between the amount of Profit after Tax and the amount of Average Total Assets. It is also expressed in the form of percentage as presented below.

$$\text{Return on Assets Ratio} = \left[\frac{\text{Amount of Net Profit}}{\text{Amount of Average Total Assets}} \times 100\right]$$

The numerator of the above formula viz., Net Profit is influenced by a few more variables such as Profit before Tax, Provision for Tax, Realized Gains or Losses on Sale of Assets, Net Operating Profit, etc. However, the amount of **Net Profit** represents the difference between Profit before Tax and the Provision for Tax.

$$\left[\begin{matrix}\text{Net Profit}\\(\textit{i.e.}, \text{ after Tax})\end{matrix}\right] = \left[\begin{matrix}\text{Profit before}\\\text{Tax}\end{matrix}\right] - \left[\begin{matrix}\text{Provision for}\\\text{Tax}\end{matrix}\right]$$

It may be noted here that the amount of **Profit before Tax** is computed by adding realized gains or subtracting losses on sale of assets to/from the Net Operating Profit.

$$\left[\begin{matrix}\text{Profit}\\\text{before Tax}\end{matrix}\right] = \left[\begin{matrix}\text{Net Operating}\\\text{Profit}\end{matrix}\right] \pm \left[\begin{matrix}\text{Realized Gains or Losses}\\\text{on Sale of Assets}\end{matrix}\right]$$

And **Net Operating Profit** represents the excess of Operating Profit before Provision over the aggregate of (i) Provision for Loan Losses, (ii) Depreciation in Investments, and (iii) Write-offs and Other Provisions.

$$\left[\begin{matrix}\text{Net}\\\text{Operating}\\\text{Profit}\end{matrix}\right] = \left[\begin{matrix}\text{Operating Profit}\\\text{before}\\\text{Provisions}\end{matrix}\right] - \left[\begin{matrix}\text{Provision}\\\text{for Loan}\\\text{Losses}\end{matrix} + \begin{matrix}\text{Depreciation}\\\text{in}\\\text{Investments}\end{matrix} + \begin{matrix}\text{Write-offs}\\\text{and other}\\\text{Provisions}\end{matrix}\right]$$

The difference between Total Income and Total Operating Expenses represents the Operating Profit before Provisions.

$$\left[\begin{matrix}\text{Operating Profit}\\\text{before Provisions}\end{matrix}\right] = \left[\begin{matrix}\text{Total}\\\text{Income}\end{matrix}\right] - \left[\begin{matrix}\text{Total Operating}\\\text{Expenses}\end{matrix}\right]$$

The fourth key area is the Leverage and it is indicated by the Leverage Ratio which is computed as below.

$$\left[\begin{matrix}\text{Leverage}\\\text{Ratio}\end{matrix}\right] = \left[\frac{\text{Capital Measure}}{\text{Exposure Measure}} \times 100\right]$$

This is a simple, transparent and non-risk based Leverage Ratio calibrated to act as a credible supplementary measure to the risk-based capital requirements.

In the light of the above conceptual framework, further analysis is made in the following paragraphs.

Review of Literature

For the purpose of improving their efficiency, it is necessary for the banks to improve their asset quality which depends upon the recovery of loans.This is because of the reason that any upsurge in the over-dues results in high level of

NPAs leading to deterioration in the asset quality which in turn reduces further the lending capacity of banks. This results in the attenuation of funds for developmental activities. Therefore, both the GOI and the RBI have made attempts to control the NPAs. Unfortunately, the commercial banks have not been able to resolve the issue of NPAs (Monika Kashyap, 2014).

There are evidences to show the substantial increase in the NPA Ratio of Indian banks attributed to the introduction of fair value accounting of banks' assets. And it is more likely to spread to the banking organizations which are inherently weak with regard to capital adequacy, etc (Subramanyam M, May 2012). In order to address the NPAs of banks and to restructure corporate debts in India, forensic auditing strategy is also suggested. Even the apex bank encourages the banks to use this strategy to investigate money laundering allegations and also the companies involved with high-profile default such as Bhushan Steel Ltd., Kingfisher Airlines Ltd., etc (FRPT- Finance Snapshot, 10 December 2014).

When a borrower fails to meet his obligation or defaults on his commitment, credit risk arises. And the increase in credit risk is a symptom of financial crisis in the banking sector. Increasing risk of default requires increase in equity of commercial banks as per Basel - III which is very difficult for the small- and medium-sized banks in the short time. Therefore, the requirement of Basel - III has forced the banks (in Katowice) to limit their active operations i.e.,reducing lending and sale of treasury bonds of countries with a low credit rating (Joanna Cichorska, 2014).

Though the Chinese authorities have introduced substantial capital into the banking system for the purpose of lowering the high level of NPLs, the results support the moral hazard hypothesis suggesting that an increase in the NPL Ratio enhancing riskier lending causing further deterioration in loan quality and financial system instability (Dayong Zhang, Jing Cai, David G Dickinson & Ali M Kutan, February 2016).

Regulators and the financial institutions in the US and other countries have taken many steps to address the problem of persistent troubled assets on their banks' balance sheets. These measures include, among others, the announcement of asset guarantee schemes by the governments. A few countries have also initiated the process of selling the troubled assets, and the third approach is the formation of 'bad banks' enabling the banking and financial institutions to sell their troubled assets into a new entity i.e., bad banks(Anna T Pinedo, September 2009). An analysis of a few US-based systemically important financial institutions covering a period of 10 years from 2000 to 2010 reiterated the fact that NPAs and operating efficiency are significant determinants. However, Tier - I Capital Ratio is not a significant indicator of default risk (Natalya A. Schenck, 2014).

An evaluation,using the Panel VAR Methods, of sensitivity of NPLs to shocks of six industries in Barbados (viz.,agriculture and fishing, construction, distribution, manufacturing, mining and quarrying, and professional services and tourism) has revealed some degree of heterogeneity in the response of NPLs to these shocks? No evidence to suggest that shocks to the agriculture and manufacturing sectors (two small sectors) affect NPLs; and the positive shocks to the output of distribution, and professional services and tourism resulting in the overall decline in the level of stress in the financial system (Anton Belgrave, Kester Guy & Mahalia Jackman, December 2012).

An analysis of profitability of 16 Indian banks was found to be reasonable during 2000-01 - 2006-07 when compared to the previous years. Return on Investment, overall profitability indicator, was at a moderate rate. With regard to Debt-Equity position, these banks maintained 1:1 ratio though it was very high for some period. Though Capital Adequacy Ratio was constant, Interest Coverage Ratio registered a continuous increase. It was found that Return on New Worth had a negative correlation with the Debt-Equity Ratio. Besides, Interest Income to Working Funds also had a negative association with the Interest Coverage Ratio. Further, NPAs to Net Advances

was negatively correlated with the Interest Coverage Ratio (Harish Kumar Singla, February 2008). The change in profit is usually attributed to changes in revenue (desirable outputs) and cost i.e.,risk and inputs(Jia-ChingJuo, April 2014). Further, weaknesses in the performance of banking and financial institutions can be measured with the help of return on average assets, NPLs, and equity to assets (James B Bexley & Jonathan Breazeale, Winter 2012).

Profitability of banks, as in any other sector, depends upon their volume of performing assets, customer orientation, operational efficiency, optimal level of operation, etc. Another crucial determinant is their ability to build up large volumes of quality assets while complying with the prudential norms. Besides, productivity and efficiency play a vital role in the banking industry. Continuous up-gradation at all levels, and commitment to the vision and mission of banks require the attention of banks in future, and in all likelihood, only those banks which are pro-active responding quickly to the changing needs of customers with due attention for the changing scenario will survive and prosper in this competitive world (Vibha Jain (2007).

On the lines of the above, there are many more studies undertaken by the researchers in the past on different aspects of performance evaluation of banking institutions including the management of NPAs. However, the above analysis brings the point to the fore that capital adequacy, asset quality and profitability are vital areas wherein the banks have to focus to improve their CAR/ CRAR, to lower their Net NPA Ratio and to maximize theirRoA Ratio (Figure - 2).

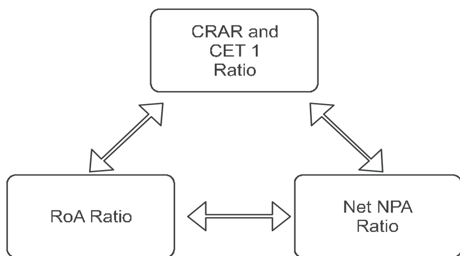

Figure - 2: Inter-relationship among Financial Performance Indicators

The success of banks in the areas of capital adequacy and profitability depend upon how effectively they manage their NPA to lower their NPA. This highlights the need for, and importance of, reducing the NPAs. In order to combat the mounting menace of NPL/NPA, the Indian regulatory authorities have initiated a few measures which are summarized below.

Measures for addressing NPA Menace

Both the RBI and the GOI have formulated and introduced a few schemes to address and resolve the problem of NPAs. These include, among others, the following (Inchara P M Gowda & Manjunatha K R, March 2017).

(1)SARFAESI Act, 2002 (The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002) has been enacted with the objective of speeding up the recovery process and to empower the lending banks/financial institutions to recover their NPAs without the intervention of courts. To strengthen the hands of the lending banks, the Act provides two alternative mechanisms viz.,

(a) Securitization empowering the secured creditors to take possession of the securities offered by the borrowers if they fail to adhere to the payment schedule and to sell such securities for recovering their loan.

(b) Setting up of Securitization/ Reconstruction Companies (SCs/RCs) to acquire the NPAs from the banks thereby cleaning the banks' balance sheets and enabling them to concentrate on their primary business. Further, the Act empowers the SCs/RCs to take possession of the secured assets of borrowers including right to transfer and realize the secured assets.

(2) Establishment of 33 **Debts Recovery Tribunals** (DRTs) and 5 **Debts Recovery Appellate** Tribunals(DRTs)by the GOI (under the Provisions of Recovery of Debts Due to

Banks and Financial Institutions Act, 1993) for the speedy adjudication and recovery of debts due to banking institutions (with outstanding amount of ` 10 lakh and above).

(3) Lok Adalats is an alternative disputes resolution (ADR) mechanism enabling the expeditious, in-expensive and mutually acceptable means of settling the disputes between the lending banks and borrowing parties.

(4) RBI's Schemes: For the purpose of enabling the banks to resolve the problem of their stressed assets, the RBI has designed and introduced a few schemes. These include the following, among others.

(a) Joint Lenders' Forum (JLF) to empower the smaller lender-banks,

(b) Corporate Debt Restructuring (CDR, 2001) enabling the banks to help the ailing corporates with additional funds based on majority decision,

(c) Strategic Debt Restructuring (SDR, 2015) enabling the lender-banks to take control of management and to convert their outstanding loans into majority equity stake,

(d) Flexible refinancing under 5/25 Scheme, etc.

(e) The apex bank has also come out in June 2016 with a new scheme called, Scheme for Sustainable Structuring of Stressed Assets (S4A) as another option for the banks to deal with the stressed assets arising out of their corporate lending.

(5) In the Economic Survey, 2016-17, the GOI mooted the idea of establishing a new central agency called, Public Sector Asset Rehabilitation Agency (PARA) to address the largest and the most difficult cases and to take politically tough decisions to reduce the debt of public sector which in turn enable the banks to reduce their NPAs (Inchara P. M Gowda, March 2017).

However, the outcome of these exercises is not satisfactory as the problem remained unresolved. Hence, the apex bank of the country has issued the Revised Prompt Corrective Action (PCA) Framework requiring the banks to implement the actions specified in the Framework if applicable to them.It may be noted here that the apex bank had issued a similar Framework way back in December 2002 (RBI, 21 December 2002) after considering the suggestions received from the bankers and others, and after its approval by the Board for Financial Supervision (BFS) and the GOI.This earlier Framework (of December 2002) identified the trigger points (i.e.,minimum/ maximum limit in performance indicator of each key area - causing the initiation of action as stipulated in the Framework if the performance of a bank reached or crossed any of these trigger points), structured actions and discretionary actions. This 2002 PCA Framework made it very clear that, if (i) the CRAR of any SCB falls below 9 per cent or (ii) if its Net NPA Ratio is 10 per cent or more, or (iii) if its ROA falls below 0.25 per cent, then that bank falls within the PCA Framework.Further, within each of the first two minimum/maximum performance indicators(as above), the apex bank made 2 - 3 zones/slabs and the actions (both Structured Actions and Discretionary Actions) differed from one zone/ slab (of performance) to another.

Revised PCA Framework, 2017 - Key Areas, Indicators and Risk Thresholds

The apex bank reviewed and revised the existing 2002 PCA Framework, and the Revised PCA Framework has been issued on 13 April 2017 (RBI, 13 April 2017). The salient features of the Revised PCA Framework are presented below.The apex bank has stipulated the minimum/maximum limit for each performance indicator. If the performance of any bank falls below this minimum limit or exceeds the maximum limit, then the bank will fall within the scope of Revised PCA Framework.

(1) Capital Adequacy - Indicators and Risk Thresholds: As far as the Capital Adequacy is concerned, the Revised PCA Framework

uses two indicators and 2 - 3 Risk Thresholds. The two indicators are CRAR and CET - 1 Ratio. In the case of CRAR, the minimum ratio is 10.25% (i.e., 9% Minimum Total Capital + 1.25% of CCB)1. And it is 6.75% in the case of CET - 1 Ratio. If the CRAR is less-than 10.25% and/or if the CET - 1 is less than 6.75%, it triggers the Revised PCA. That means, if the CRAR is 10.25% or more, and CET - 1 is 6.75% or more, it does not trigger the Revised PCA. Within this minimum capital requirement, the Framework identifies 2 - 3 Risk Thresholds as detailed below.

(a) Risk Threshold – 1: CRAR is $\geq$ 7.75% but < 10.25% (*i.e.,* up to 250 bps[2] below indicator) and/or CET – 1 Ratio is $\geq$ 5.125% but < 6.75% (*i.e.,* up to 162.50 bps below indicator).

(b) Risk Threshold – 2: CRAR is $\geq$ 6.25% but < 7.75% (*i.e.,* more than 250 bps but not exceeding 400 bps below indicator) and/or CET – 1 Ratio $\geq$ 3.625% but < 5.125% (*i.e.,* more than 162.50 bps but not exceeding 312.50 bps below indicator).

(c) Risk Threshold – 3: CET – 1 is less-than 3.625 per cent.

(2) Asset Quality- Indicators and Risk Thresholds: For the purpose of evaluating the asset quality, Net Non-performing Advances[3] Ratio is used. In the earlier PCA Framework (2002), only two zones were used viz., Net NPA Ratio is > 10% but < 15%, and $\geq$ 15%. That means, if the Net NPA Ratio of a bank is 10 per cent or less, it does not trigger PCA. All other banks whose Net NPA Ratios were higher than 10 per cent attracted PCA. But now, in the Revised PCA Framework, the apex bank made two important changes - (i) increase the number of zones to three as Risk Thresholds - 1, 2 and 3, and (ii) reducing the minimum trigger point from greater-than 10 per cent to 6 per cent as detailed below.

(a) Risk Threshold - 1: Net NPA Ratio is $\geq$ 6% but < 9%.

(b) Risk Threshold - 2: Net NPA Ratio is $\geq$ 9% but < 12%.

(c) Risk Threshold - 3:Net NPA Ratio is $\geq$ 12%.

(3) Profitability- Indicators and Risk Thresholds: As far as the measurement of profitability is concerned, there is no change in the indicator as the RoA continues to be the yardstick to measure the profitability. However, the Revised PCA Framework has created three Risk Thresholds - 1, 2 and 3 as against only one trigger point in the 2002 PCA Framework. Further, the Revised PCA Framework has done away with < 0.25 per cent limit (used in the 2002 PCA Framework) as evident from the following.

(a) Risk Threshold - 1: Negative ROA for two consecutive years

(b) Risk Threshold - 2: Negative ROA for three consecutive years

(c) Risk Threshold - 3: Negative ROA for four consecutive years

(4) Leverage- Indicators and Risk Thresholds: This is an additional key area used by the apex bank in the Revised PCA Framework and to assess the performance of a bank from the point of view of Leverage, Tier - 1 Leverage Ratio (i.e., the percentage of Capital Measure to Exposure Measure) is specified. In this regard, the Revised PCA Framework uses two Risk Thresholds - 1 and 2 as detailed below.

(a) Risk Threshold - 1: Tier - 1 Leverage Ratio is $\leq$ 4.0% but $\geq$ 3.5%

(i.e., leverage is over 25 times the Tier - 1 Capital)

(b) Risk Threshold - 2: Tier - 1 Leverage Ratio is < 3.5% (i.e., leverage is over 28.6 times the Tier - 1 Capital)

It may be noted from the above that higher the zone/Risk Threshold Number, higher is the gravity of the problem requiring more stringent actions as evident from the following.

Revised PCA Framework, 2017 -Corrective Actions

As far as the prompt corrective actions are concerned, the apex bank has made certain

changes in the Revised PCA Framework as compared to the 2002 PCA Framework. One is the restructuring of 'Structured Actions' as 'Mandatory Actions'. These Mandatory Actions are common for all key areas and performance indicators. 4However,the mandatory actions differ from one Risk Threshold to another. The second important change is in 'Discretionary Actions'. The Revised PCA Framework specifies 'common menu' for selection of discretionary corrective actions. 4It may be noted here that the Revised PCAFramework applies to all banks operating in India on breach of Risk Thresholds of identified indicators. These banks include even the small banks, and branches and subsidiaries of foreign banks.

Further, a bank will be placed under the Revised PCA Framework based on its audited annual financial results and the supervisory assessment made by the apex bank. Besides, the apex bank is empowered to impose the Revised PCA Framework on any bank during the course of a year (including migration from one Threshold to another) if the circumstances warrant. The Provisions of this Revised PCA Framework will be effective from 1 April 2017 based on the financial results of the banks for the year ended 31 March 2017. And these Provisions will be in force for a period of three years from 1 April 2017 and the apex bank intends to review the same after three years.

In the light of the above, the prescribed actions - both Mandatory and Discretionary - are presented below. It may be noted here that, besides the corrective actions prescribed below, the Revised PCA Framework does not preclude the apex bank from taking any other action as it deems fit.

(1) Mandatory Actions: As already pointed out, these actions are common for all banks which trigger PCA. Further, all mandatory actions specified for Risk Threshold - 1 are applicable even for the subsequent Thresholds - 2 and 3 but not vice-versa.The Revised PCA Framework prescribes the following mandatory actions for different Risk Thresholds. Hence, the banks which fall within the Revised PCA Framework have no other option except implementing these mandatory actions fully and with all seriousness.

(a) Risk Thresholds - 1, 2 and 3: Any bank which breaches either CRAR or CET - 1 Ratio or Net NPA Ratio or RoA Ratio or Leverage Ratio or any combination of these Ratios is subject to restriction on dividend distribution/remittance of profits. Further, the Promoters/owners/parent in the case of foreign banks are required to bring in capital.

(b) Risk Threshold - 2: Additionally, the banks are subject to restriction on branch expansion - domestic and/or overseas (this action is also applicable to Risk Threshold - 3). Further, the banks are required to make higher provisions as part of the coverage regime.

(c) Risk Threshold - 2: Additional action is the restriction on management compensation and directors' fees, as applicable.

These actions aim at improving the CRAR and ROA Ratio, and reducing the Net NPA Ratio by increasing the capital base, reducing expenses and appropriations, etc.

(2) Discretionary Actions: The Revised PCA Framework prescribes a common menu with specified actions for each of nine specific issue areas, and from this common menu, the relevant corrective actions are required to be chosen and executed depending upon the area wherein the performance of a bank triggers actions. The nine broad areas and the corrective actions prescribed are summarized below.

(a) Special Supervisory Interactions comprise (i) Special Supervisory Monitoring Meetings (SSMMs) at quarterly or other identified frequency, (ii) special inspections/ targeted scrutiny of the bank, and (iii) special audit of the bank.

(b) **Strategy-related Actions:** The apex bank to advise the bank's Board to (i) activate the Recovery Plan, (ii) undertake a detailed review of business model in terms of sustainability of the business model, profitability of business lines, medium- and long-term viability, etc., (iii) review short- and medium-term strategies addressing immediate concerns, identifying achievable targets and setting concrete milestones for progress and achievement,etc., (iv) undertake business process reengineering and restructuring of operations as appropriate.

(c) **Governance related Actions:** The apex bank (i) to actively engage with the bank's Board on various aspects, (ii) to recommend to owners to bring in new management/Board, (iii) to remove managerial persons, (iv)to supersede the Board or to recommend supersession of the Board as applicable,etc.

(d) **Capital related Actions:** (i) Detailed Board level review of capital planning, (ii) submission of plans and proposals for raising additional capital, (iii) requiring the bank to bolster reserves through retained profits, (iv) restriction on investment in subsidiaries/associates, expansion of high risk-weighted assets to conserve capital, (v) reduction in exposure to high risk sectors to conserve capital,etc.,are some of the actions prescribed by the apex bank to tackle capital related issues.

(e) **Credit Risk related Actions:** (i) Preparation of time bound plan and commitment for reduction of stock of NPAs and for containing generation of fresh NPAs, (ii) strengthening of loan review mechanism, (iii) restrictions on/reduction in credit expansion for borrowers below certain rating grades and for unrated borrowers, (iv) reduction in loan concentrations, (v) sale of assets, (vi) setting up of dedicated Recovery Task Forces, Adalats, etc., are some of the actions listed in the common menu of Revised PCA Framework for managing credit risk.

(f) **Market Risk related Actions** comprise restrictions on/reduction in borrowings from the inter-bank market, restrictions on accessing/renewing wholesale deposits/ costly deposits/certificates of deposits, restrictions on derivative activities, restriction on excess maintenance of collateral, etc.

(g) **HR related Actions** comprise restriction on staff expansion, and review of specialized training needs of existing staff.

(h) **Profitability related Actions** consist of restrictions on capital expenditure, other than for technological upgradation within Board approved limits.

(i) **Operations related Actions:** (i) Restrictions on branch expansion plans, (ii) reduction in business at overseas branches/ subsidiaries/ in other entities, (iii) restrictions on entering into new lines of business, (iv) reduction in leverage through reduction in non-fund based business, (v) reduction in risky assets, (vi) restrictions on non-credit asset creation, etc., are the important prescriptions for operations-related issues.

The above are the actions prescribed by the RBI for the banks which, because of poor performance, trigger the Revised PCA Framework. It may be noted here that the apex bank is empowered to take any other specific action that it may deem fit considering specific circumstances of a bank.

PCA Framework, 2002 Vs 2017 - A Few Differences

A comparison of the Revised PCA Framework of 2017 with that of December 2002 reveals certain differences in terms of prescribed actions, key areas, min/max performance results attracting the Provisions of PCA Framework, etc. However,

an attempt is made here to analyze and present only a few differences.

(1) In the case of Asset Quality which is measured with the help of Net NPA Ratio, the 2002 PCA Framework made only two zones viz., (i) $>10\%$ but $<15\%$, and (ii) $\geq 15\%$. But in the Revised PCA Framework of 2017, the apex bank made three zones and also reduced upper limit of the last zone (Risk Threshold - 3). Further, instead of 'trigger points', the apex bank uses 'Risk Thresholds' now. And the three zones, in the case of Net NPA Ratio, are (i) $\geq 6\%$ but $< 9\%$, (ii) $\geq 9\%$ but $< 12\%$, and (iii) $\geq 12\%$. Similar differences can be found even in other key areas, performance indicators and the risk thresholds.

(2) In the earlier PCA Framework, only three key areas and their performance indicators were used to ascertain whether a bank falls within the PCA Framework or not. They are, Capital Adequacy (CRAR/CET - 1 Ratio), Asset Quality (Net NPA Ratio) and Profitability (ROA Ratio). But in the Revised PCA Framework, one more key area viz., Leverage is included and to measure the performance of the banks from the point of view of Leverage, Tier - 1 Leverage Ratio is used.

(3) In the 2002 PCA Framework, the apex bank stipulated both the Structured Actions and Discretionary Actions for each of the Key Areas and Trigger Points separately. But in the Revised PCA Framework, there are Mandatory Actions (in place of Structured Actions) for each of the three Thresholds and these Actions are common for all the four Key Areas. And the Common Menu for selection of Discretionary Corrective Actions is specified, in the Revised PCA Framework, for all Key Areas. And this Common Menu is related to nine specific areas such as supervisory, governance, credit risk, profitability, operations, etc.

On the lines of the above, there are a few more differences between the PCA Framework of 2002 and the Revised PCA Framework of 2017.

Conclusion

The apex bank, through the issue of Revised PCA Framework (April 2017), has made another attempt to address the NPA problem of Indian banks. It has tightened the Risk Thresholds and therefore, it is expected that more than half of PSBs would breach at least one of the new Risk Thresholds owing to high level of NPAs, and it may be noted here that if any bank fails to meet the requirements in any of these indicators or Risk Thresholds will lead to initiation of action by the apex bank on the banks concerned such as stricter norms on lending, restriction on branch expansion, change of management, merger,etc. This is because of the reason that the breach of any Risk Threshold would result in the invocation of Revised PCA. These stringent measures are expected to address the NPA problem of banks vigorously. However, one should not forget the fact that a similar scheme (i.e., PCA Framework, 2002) has been in vogue since December 2002 but the NPA problem remained unresolved. It is hoped that based on the experience with the PCA Framework, 2002, the banks, apex bank and the GOI will implement the Provisions of Revised PCA Framework, 2017 effectively to improve the performance and to reduce the NPAs of banks if they breach the Risk Thresholds. However, the primary task for all banks is to work efficiently and profitably, and to see that they do not attract the actions under Revised PCA Framework, 2017.

Notes

(1) The Capital Conservation Buffer (CCB) is required to be increased to 1.875 per cent by 31 March 2018 and to 2.5 per cent by 31 March 2019.

(2) 'bps' is used to measure the change in the (interest) rate/yield. And '1' basis point (i.e., '1' bps) means 0.01 per cent (i.e., one-hundredth of one per cent).

(3) The Revised PCA Framework uses the term 'Net Non-performing Advances'. However, the meaning is same as that of Net Non-performing Loans or Net Non-performing Assets.

(4) In 2002 PCA Framework, both the Structured and Discretionary Actions were specified for each key area,for each performance indicator and for each trigger points separately.

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