

Prompt Corrective Action (PCA) Framework

Reserve Bank of India PCA Framework for commercial banks

The Reserve Bank has specified certain regulatory trigger points, as a part of prompt corrective action (PCA) Framework, in terms of three parameters, i.e. capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and Return on Assets (RoA), for initiation of certain structured and discretionary actions in respect of banks hitting such trigger points. The PCA framework is applicable only to commercial banks and not extended to co-operative banks, non-banking financial companies (NBFCs) and FMI.

The trigger points along with structured and discretionary actions that could be taken by the Reserve Bank are described below:

1. CRAR

- (i) **CRAR less than 9%, but equal or more than 6%** - bank to submit capital restoration plan; restrictions on RWA expansion, entering into new lines of business, accessing/renewing costly deposits and CDs, and making dividend payments; order recapitalisation; restrictions on borrowing from inter-bank market, reduction of stake in subsidiaries, reducing its exposure to sensitive sectors like capital market, real estate or investment in non-SLR securities, etc.
- (ii) **CRAR less than 6%, but equal or more than 3%** - in addition to actions in hitting the first trigger point, RBI could take steps to bring in new Management/ Board, appoint consultants for business/ organizational restructuring, take steps to change ownership, and also take steps to merge the bank if it fails to submit recapitalization plan.
- (iii) **CRAR less than 3%** - in addition to actions in hitting the first and second trigger points, more close monitoring; steps to merge/amalgamate/liquidate the bank or impose moratorium on the bank if its CRAR does not improve beyond 3% within one year or within such extended period as agreed to.

2. Net NPAs

- (i) **Net NPAs over 10% but less than 15%** - special drive to reduce NPAs and contain generation of fresh NPAs; review loan policy and take steps to strengthen credit appraisal skills, follow-up of advances and suit-filed/decreed debts, put in place proper credit-risk management policies; reduce loan concentration;

restrictions in entering new lines of business, making dividend payments and increasing its stake in subsidiaries.

(ii) Net NPAs 15% and above – In addition to actions on hitting the above trigger point, bank's Board is called for discussion on corrective plan of action.

- 3. ROA less than 0.25%** - restrictions on accessing/renewing costly deposits and CDs, entering into new lines of business, bank's borrowings from inter-bank market, making dividend payments and expanding its staff; steps to increase fee-based income; contain administrative expenses; special drive to reduce NPAs and contain generation of fresh NPAs; and restrictions on incurring any capital expenditure other than for technological upgradation and for some emergency situations.

FDIC PCA Framework

The PCA framework prescribes five levels of trigger points based on capital measures, i.e. total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio, for insured state-chartered non-member banks. The five PCA categories are (i) well capitalized, (ii) adequately capitalized, (iii) undercapitalized, (iv) significantly undercapitalized, and (v) critically undercapitalized.

(i) Well capitalized –

- (a) Total risk-based capital ratio of 10% or greater; and
- (b) Tier 1 risk-based capital ratio of 6% or greater; and
- (c) Leverage ratio of 5% or greater.

(ii) Adequately capitalized -

- (a) Total risk-based capital ratio of 8% or greater; and
- (b) Tier 1 risk-based capital ratio of 4% or greater; and
- (c) A leverage ratio of 4% or greater, OR a leverage ratio of 3% or greater if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank.

(iii) Undercapitalized -

- (a) Total risk-based capital ratio of less than 8%; OR
- (b) Tier 1 risk-based capital ratio of less than 4%; OR
- (c) A leverage ratio of less than 4%, OR a leverage ratio of less than 3% if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank.

(iv) Significantly undercapitalized -

- (a) Total risk-based capital ratio of less than 6%; OR

- (b) Tier 1 risk-based capital ratio of less than 3%; OR
- (c) A leverage ratio of less than 3%.

(v) Critically undercapitalized -

- (a) The tangible equity to total assets (leverage ratio) is equal to or less than 2%.

For insured branches of foreign banks, the PCA framework has prescribed five categories in terms of pledged assets and maintenance of eligible assets. These are described below:

(i) Well capitalized -

- (a) Maintains the pledge of assets as per FDIC Rules and Regulations; and
- (b) Maintains eligible assets at 108% or more of the preceding quarter's average book value of the branch's third party liabilities; and
- (c) Has not received any written notification from OCC to increase its capital or asset management requirements.

(ii) Adequately capitalized -

- (a) Maintains the pledge of assets as per FDIC Rules and Regulations; and
- (b) Maintains eligible assets at 106% or more of the preceding quarter's average book value of the branch's third party liabilities; and
- (c) Does not meet the definition of well capitalized branch.

(iii) Undercapitalized -

- (a) Fails to maintain the pledge of assets as per FDIC Rules and Regulations; OR
- (b) Fails to maintain eligible assets at 108% or more of the preceding quarter's average book value of the branch's third party liabilities.

(iv) Significantly undercapitalized -

- (a) Fails to maintain eligible assets at 104% or more of the preceding quarter's average book value of the branch's third party liabilities.

(v) Critically undercapitalized -

- (a) Fails to maintain eligible assets at 102% or more of the preceding quarter's average book value of the branch's third party liabilities.

On bank reaching the levels of undercapitalized, or significantly undercapitalized, or critically undercapitalized, automatic restrictions, as per provisions of Section 38 of FDI Act, are placed on the concerned bank in respect of (i) payment of capital distributions and management fees, (ii) the growth of assets, (iii) requiring prior approval of certain expansion proposals, (iv) requiring that the FDIC monitor the condition of the bank, and (v) requiring submission of a capital restoration plan.

In addition to the above restrictions and close monitoring, the significantly undercapitalized and critically undercapitalized banks are restricted to pay compensation to senior executive officers of the institution. The critically undercapitalized bank is, in addition to above, required to take prior approval from FDIC in respect of – entering into any material transaction other than in the usual course of business, such as any investment, expansion, acquisition, sale of assets, or other similar action; extending credit for any highly leveraged transaction; amending the institution’s charter or bylaws; making any material change in accounting methods; paying excessive compensation or bonuses; paying significantly high interest on new or renewed liabilities; making any principal or interest payment on subordinated debt beginning 60 days after becoming critically undercapitalized; and engaging in any covered transaction. In addition, FDIC may further restrict the activities of the critically undercapitalized bank.

Early Intervention Framework in Canada

The Canadian framework of early intervention (issued by the Office of the Superintendent of Financial Institutions (OSFI)) consists of four stages (in addition to the “all normal” stage). Each stage is identified by a set of conditions and a number of options for supervisory measures. The framework also includes guidelines for the interaction between the authorities, including the Canada Deposit Insurance Corporation (CDIC).

(i) Stage 1 – Early Warning -

- (a) The combination of the institution’s overall net risk and its capital and earnings compromises the institution’s resilience; and
- (b) The institution has issues in its risk management or has control deficiencies that, although not serious enough to present a threat to financial viability or solvency, could deteriorate into more serious problems if not addressed.

Supervisory actions include – meeting the bank’s management, conducting more frequent and intrusive on-site supervision, and requiring additional and more frequent reporting. The OSFI informs the CDIC about the institution’s position and actions intended to take. OSFI will also send intervention reports to the CDIC and they will hold joint meetings to discuss the risk profile of the institution.

(ii) Stage 2 – Risk to financial viability or solvency -

- (a) The combination of the institution’s overall net risk, capital and earnings makes it vulnerable to adverse business and economic conditions which may pose a serious threat to its financial viability or solvency; and

- (b) The institution has issues in its risk management that, although not serious enough to present an immediate threat to financial viability or solvency, could deteriorate into more serious problems if not addressed.

Supervisory actions include – requiring the institution to rectify problems within a specified timeframe, requiring the institution’s external auditor to extend the scope of the review of the financial statements or to conduct other procedures as specified by the OSFI, or developing a contingency plan to enable the OSFI to take rapid control of the assets of the institution in case of rapid deterioration. At this stage, OSFI will inform the CDIC of results and data obtained from enhanced supervisory reviews, expanded audits, and enhanced monitoring. The OSFI and CDIC will commence contingency planning.

(iii) Stage 3 – Future financial stability in serious doubt -

- (a) The combination of the institution’s overall net risk, capital and earnings makes it vulnerable to adverse business and economic conditions which pose a serious threat to its financial viability or solvency; and
- (b) The institution has significant issues in its risk management or control deficiencies, which present a serious threat to financial viability or solvency, unless effective corrective action is promptly implemented.

Supervisory actions include – directing specialists to assess specific areas such as the quality of loan security, asset values, and sufficiency of reserves; enhancing the scope of business restrictions put on the institution; sending OSFI staff to the institution to monitor the situation on an ongoing basis; expanding contingency planning; and communicating to the management the importance of considering resolution options, including seeking a prospective purchaser. The CDIC and OSFI will discuss the situation of the institution in depth.

(iv) Stage 4 – Non-viability/insolvency imminent -

- (a) The institution has failed to meet regulatory capital requirements in conjunction with an inability to rectify the situation on an immediate basis;
- (b) The statutory conditions for taking control have been met; and
- (c) The institution has failed to develop and implement an acceptable business plan, resulting in either of the two preceding circumstances becoming inevitable within a short period of time.

At this stage, OSFI has determined that the financial institution will become non-viable on an immediate basis. The supervisory actions include – assuming temporary control or taking control of the assets; and requesting that the Attorney General apply for a winding-up order.

Early Intervention Framework in Denmark

The Danish framework consists of five quantitative indicators. The supervisor is authorized to take remedial action in cases where the limits are breached. The five indicators are –

- (i) Aggregate sum of all large exposures must not exceed 125 per cent of the bank's core capital. (Large exposure is defined as the sum of exposures to a client or to a group of connected clients, if it exceeds 10% of the bank's core capital);
- (ii) Bank's lending growth must not exceed 20% per year;
- (iii) Amount of lending for real estate must not exceed 25% of total lending;
- (iv) Bank's funding ratio must not exceed 1. (Funding ratio is defined as aggregate lending divided by working capital (all shares, junior and senior debt, but excluding debt shorter than one year)).
- (v) Liquidity coverage, defined as retail deposits in relation to wholesale funding must be at least 50%. In addition, the LCR and NSFR prescribed by Basel III will apply for liquidity and funding.