Mains Practice Question

Q. Among the mainstream banks, eleven government banks are under RBI's Prompt Corrective Action (PCA) framework. Discuss the need for PCA and its impact on public sector banks and economy at large. (250 words)

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Approach

- Brief Introduction
- Need for PCA
- Impact (positive and negative) on public sector banks and economy at large.
- Way Forward

Introduction

- PCA is a framework under which banks with weak financial metrics are put under watch by the RBI.
- The RBI introduced the PCA framework in 2002 as a structured early-intervention mechanism for banks that become under-capitalized due to poor asset quality, or vulnerable due to loss of profitability.
- It aims to check the problem of Non-Performing Assets (NPAs) in the Indian banking sector.

Body

Need for PCA

- The rising NPA in public sector banks has led RBI to implement PCA mechanism to ensure that banks don't lose their creditworthiness. Essentially PCA helps RBI monitor key performance indicators of banks, and take corrective measures, to restore the financial health of a bank.
- Under PCA, RBI can place restrictions on dividend distribution, branch expansion, and management compensation, only in an extreme situation, resolution through amalgamation, reconstruction or winding up is taken. RBI may also impose restrictions on borrowings from interbank market and lending credit to unrated borrowers or those with high risks, but RBI doesn't invoke a complete ban on their lending business.
- The idea is to head off problems and avoid crisis situation. The PCA framework deems banks as risky if they slip some trigger points - capital to risk weighted assets ratio (CRAR), net NPA, Return on Assets (RoA) and Tier 1 Leverage ratio.

Impact on public sector banks and economy at large:

Positive impact

- To alert the investors and depositors if a bank is headed for trouble.
- It encourages banks to hold more capital as advocated under BASEL III norms and to minimize the possibility of triggering mandatory supervisory action.
- It will help create sound banking system in the long run, thereby protecting investors and ensuring

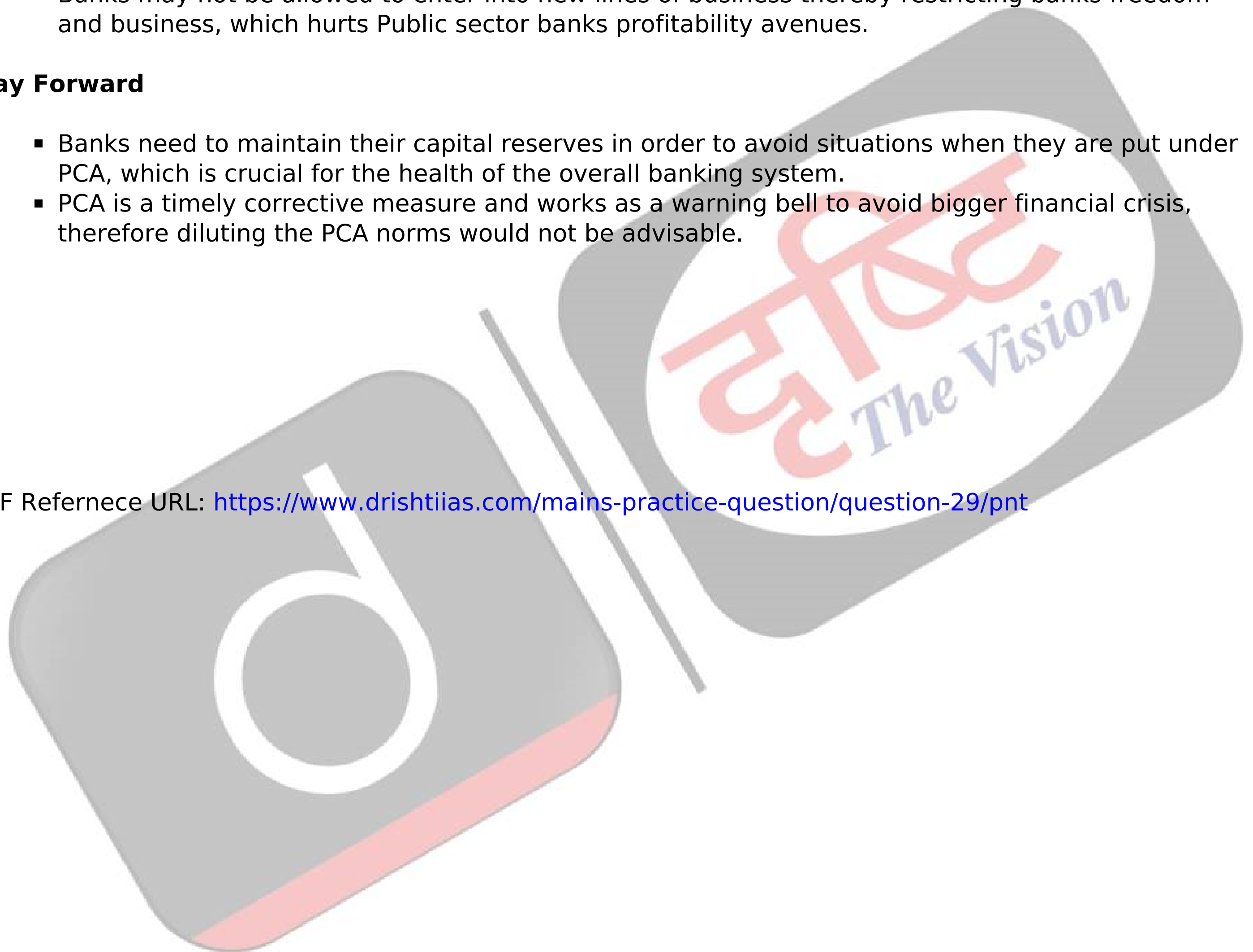
macroeconomic stability.

Negative impact

- The PCA framework is applicable only to commercial banks and not to co-operative banks and non-banking financial companies (NBFCs).
- PCA is an exceptional action and impacts the rating of the bank as well as consumer confidence. This is detrimental in the long run as it impacts the credit history of the bank and raises questions about its management.
- PCA can accelerate the loss of market share and cause further decline of the position of the public sector banks in the financial system in favour of private banks and foreign banks.
- PCA is seen by government as hindering economic growth therefore is arguing for easier lending policies by relaxing the PCA norms and aligning them to global norms.
- RBI may also impose restrictions on the bank on borrowings from interbank market which restricts credit borrowing and therefore hurts the overall economy.
- Banks may not be allowed to enter into new lines of business thereby restricting banks freedom and business, which hurts Public sector banks profitability avenues.

Way Forward

- Banks need to maintain their capital reserves in order to avoid situations when they are put under PCA, which is crucial for the health of the overall banking system.
- PCA is a timely corrective measure and works as a warning bell to avoid bigger financial crisis, therefore diluting the PCA norms would not be advisable.



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