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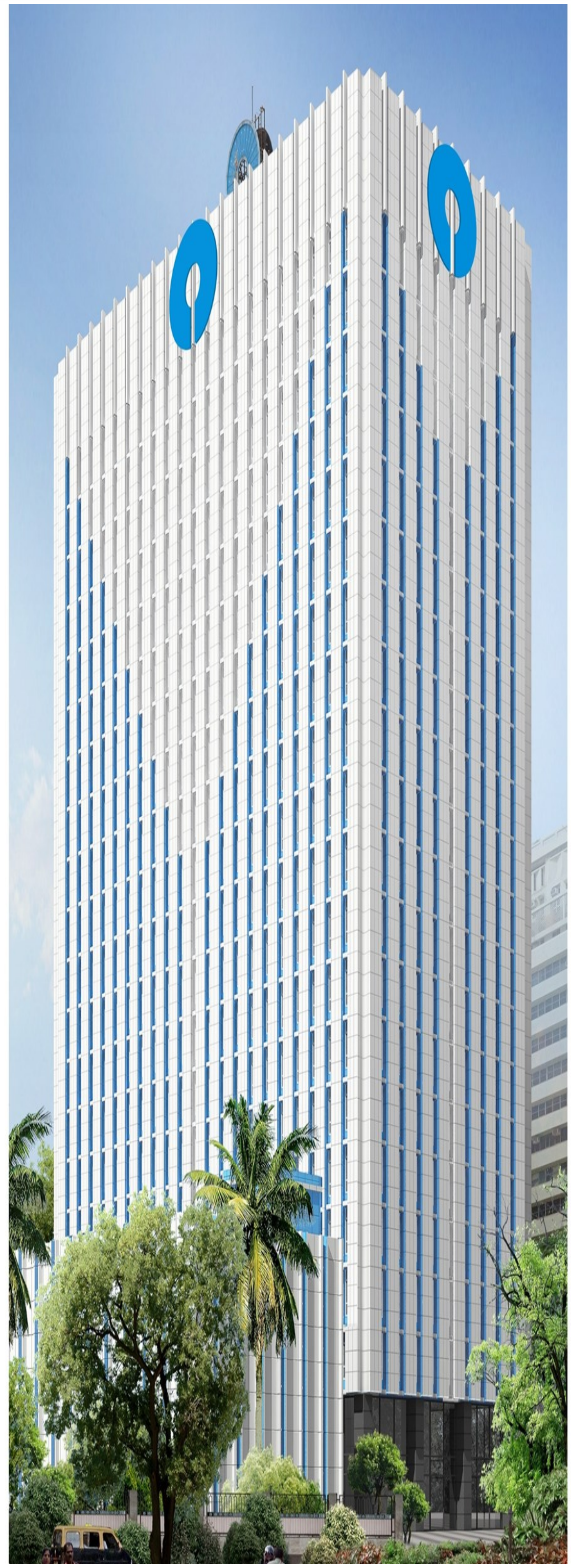

PCA AND PROVISIONING NORMS IN INDIA ARE STRICTLY RULE BASED AS OPPOSED TO US

Recently, there is a public debate regarding relaxation of the Prompt Corrective Action (PCA) norms imposed on 11 public sector banks (PSBs). The PCA framework is employed internationally by bank supervisors and regulators as an accepted form of structured early intervention and resolution, designed to help banks regain health by preserving capital.

We believe that the US FDIC framework, is based more on constrained discretion rules that are applied contextually. In contrast, PCA framework in India is more rule based and hence more stringent. Interestingly, a comparison of Indian and US PCA framework reminds us of Ben Bernanke terminology (2003) of how constrained discretion rules might achieve the desired objective of monetary policy making rather than strict rule based approach. Additionally, to borrow from behavioral economics, regulators can be expected to employ their discretion advantageously when there is an opportunity for learning via repeated practice and discussions. Perhaps US PCA framework encompasses more learning by doing and hence more effective and less stringent.

Simultaneously, provisioning norms in India are also strictly rule based and **thereby entail Indian banks to hold more provisions**. In principle, Indian banks are subjected to gradual age wise provision for substandard assets starting from 15% In 1st year to 25%, 40% and 100% in subsequent years irrespective of whether collateral is available or not. Higher provisions are must for unsecured substandard assets.

In contrast, in US, provisioning norms are purely discretion based and are provided for by each bank as per estimated/ judgmental / modelling credit losses associated with the loan portfolio. In case of a commercial loan, the fair value of the collateral is always taken into consideration if the loan is collateral dependent to account for provisioning, if any. For a mortgage loan, only on 270 days delinquent, mortgage are placed on non-accrual status only if the realizable value of the collateral is less than the unpaid principal balance plus accrued interest. In fact, if a mortgage loan is fully insured, it is not even placed on non-accrual status even after default status.

But even after all this: Indian banks recapitalisation over the years is not even 1% of US banks, even after considering the current asset quality issues. Actually, recapitalization is a gross transfer to the Government if we take dividends and taxes paid to Government by banks!

PCA NORMS IN INDIA & USA: THE BACKGROUND

- Recently, there is a public debate regarding relaxation of the Prompt Corrective Action (PCA) norms imposed on 11 public sector banks (PSBs). The PCA framework is employed internationally by bank supervisors and regulators as an accepted form of structured early intervention and resolution, designed to help banks regain health by preserving capital. Imposition of PCA can thus be seen as first, stabilising the banks at risk, and then, undertaking the deeper bank reforms needed for long-term viability of the business model of these banks.
- In the post crisis period, around 500 US banks have failed (although most are community banks) at a cost of approximately $75 billion to the Deposit Insurance Fund (DIF) and this gave away to FDIC PCA bank framework in USA.
- In the Indian context, prior to 1969, the Indian banking system was very weak and dominated by small unviable banks owned by business houses. So, in 1960, RBI was empowered to bring compulsory mergers and integrations. In the post-1960 period, there were large numbers of compulsory mergers (particularly 30 in 1961) and integrations (transfer of assets/liabilities; 62 in 1964). The elimination of weak banks helped boost economic efficiency and financial integrity, leading to an improved banking structure.
- The US FDIC framework, is based more on constrained discretion rules that are applied contextually. In contrast, PCA framework in India is more rule based and hence more stringent. Interestingly, a comparison of Indian and US PCA framework reminds us of Ben Bernanke terminology (2003) of how constrained discretion rules might achieve the desired objective of monetary policy making rather than strict rule based approach. Additionally, to borrow from behavioral economics, regulators can be expected to employ their discretion advantageously when there is an opportunity for learning via repeated practice and discussions. Perhaps US PCA framework encompasses more learning by doing and hence more effective and less stringent.
- While it may be difficult to vouch for either a rule based approach or a discretion based approach to policy making, empirical research does suggest (Greg Mankiw) that discretion based approach could also serve the desired purpose if the regulator has credibility.

RBI PCA FRAMEWORK

- RBI PCA framework was introduced in December 2002 as a structured early intervention mechanism along the lines of the FDIC's PCA framework. Subsequently, the framework was reviewed by RBI by adopting the international best practices and was implemented with respect to the bank financials as on March 31, 2017.
- RBI 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.
- Currently, there are 11 PSBs are under PCA framework of RBI.

RBI PCA Framework

Areas	Indicator	Threshold 1	Threshold 2	Threshold 3
Capital (Breach of either CRAR or CET 1 ratio)	CRAR- Regulatory capital + CCB=10.875% (9%+ 1.875% as on March 18) And/Or CET1+CCB = 7.375% (5.5%+1.875% as on March 18)	Upto 250 bps below indicator <**10.875** but >=8.375 Upto 162.50 bps below indicator <7.375% but >=5.75	More than 250 bps and up to 400 bps below indictor <8.375 but>=6.875% More than 162.5 bps and upto 312.5 bps below indicator <5.75 but>=4.25%	- - In excess of 312.50 bps below indicator <4.25%
Asset Quality	Net NPA	>= 6% but <9%	>=9% but<12%	>=12%
Profitability	Return on Assets (ROA)	Negative for two consecutive year	Negative for three consecutive year	Negative for four consecutive year
Leverage	Tier 1 leverage ratio	<=4% but>=3.5% (over 25 times of time 1 capital)	<3.5% (over 28.6 times of time 1 capital)	

US PCA FRAMEWORK

- The US has a dual banking system, where Banks or Depository Institutions, may be chartered by either federal or state authorities. The office of the Comptroller of the Currency (OCC) is the federal bank regulator with the power to charter national banks. The OCC is part of the US treasury department. Separately, each state also has a regulatory agency to charter either banks or thrifts. The Federal Depository Insurance Corporation (FDIC) is the primary federal supervisor of state.
- Thresholds of performance (in case of FDIC, bank capitalisation) are identified to classify banks that breach the thresholds into categories, for instance, in the case of FDIC into "under-capitalised", "significantly under-capitalised" and "critically under-capitalised". The first thresholds are set at levels that are well above what would allow for an effective resolution or revival of banks.
- Banks that do not meet the thresholds are subjected to a layered, progressively stringent "program", consisting of mandatory and discretionary regulatory actions.

PROVISIONING REQUIREMENT IN INDIA

- In India, in line with the prudential norms, provisions are to be made on the non-performing assets on the basis of classification of assets into prescribed categories, taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realization of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against substandard assets, doubtful assets and loss assets. In addition, Banks required to make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis in the range of 0.25% to 1% (SME- 0.25% and CRE-1%. **As mentioned earlier, provisioning requirements in India is thus strictly rule based.**

RBI's Provisioning Framework			
Asset Class	**Description**		**Provision**
Non-Performing Assets	Interest and/ or instalment of principal remains overdue for a period of more than 90 days		As under
Substandard Assets	Remained NPA for a period less than or equal to 12 months	General Provision For Unsecured	15% 25%
Doubtful	Remained in the substandard category for a period of 12 months	For Unsecured Up to one year One year to three years More than three years	100% 25% 40% 100%
Loss	Identified by the bank or internal or external auditors or the RBI inspection		100%

PROVISIONING REQUIREMENT IN USA

- **However, in US provisioning framework is entirely based on allowance on credit loss and hence is discretion based**. As per FDIC Loans policy guidelines, each bank must maintain an Allowance for Loan and Lease Losses (ALLL) adequate to absorb its own estimated / judgmental / modelling credit losses associated with the loan and lease portfolio, i.e., loans and leases that the bank has the intent and ability to hold for the foreseeable future or until maturity or payoff. Each bank should also maintain, as a separate liability account, an allowance sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments.
- As far as retail loans are concerned, while analyzing the annual reports of large Banks in US, we observe in accordance with the policies consumer real estate loans, including residential mortgages and home equity loans, if they are insured are not reported as nonperforming after 90 days.

- Furthermore, when a residential loan reaches 90 days delinquent, it may not be provisioned for but subject to an impairment test. At 180 days delinquent, the loan is again subject to further impairment testing. On 270 days delinquent, all first lien mortgage are placed on non-accrual status only if the realizable value of the collateral is less than the unpaid principal balance plus accrued interest. An impaired allowance is measured based upon the loan's market value, the present value of expected future cash flows, discounted at the loan's initial effective interest rate.
- In case of a commercial loan, the fair value of the collateral is taken into consideration if the loan is collateral dependent to account for provisioning, if any. If the loan valuation is less than the recorded value of the loan, an impairment allowance is established by a provision for credit loss.
- While FDIC triggers the PCA based on bank capital thresholds and leverage, the Reserve Bank's PCA thresholds also include asset quality and profitability, though ultimately profitability and asset quality will reflect in strength of the capital.
- The estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (GAAP).

Comparison of PCA and Provisioning Norms of FDIC and RBI

Area	FDIC	RBI
Risk Capital	1st threshold level kick in when risk capital goes below 8% and 2nd threshold when it goes below 6%	1st threshold level kick in much earlier i.e. when risk capital goes below 10.875% and 2nd threshold when it goes below 8.375%
CET1	1st threshold level triggers below 4.5% and 2nd threshold when it goes below 3%	1st threshold level kick in much earlier i.e. when risk capital goes below 7.375% and 2nd threshold when it goes below 5.7%
Leverage	1st triggers below 4% and 2nd threshold when it goes below 3%	1st triggers below 4.5% and 2nd threshold when it goes below 3.5%
Mandatory / Rule Based Actions	♦ Restriction on growth of the assets, ♦ Payment of dividend kick in from 1st threshold with increasing restrictions such as transaction with affiliates, deposit from correspondent bank, restricting credit for any high leveraged transactions with increasing threshold.	♦ Dividend Restriction ♦ Bringing in more Capital etc. from threshold level 1 ♦ Restriction on Branch Expansion ♦ Restriction on compensation and Director's fee kicks in 2nd and 3rd level of threshold
Discretionary actions	Discretionary action includes application of Level 2 threshold action at Level 1 threshold level itself and otherwise.	Host of common menu on areas related to Supervision, Strategy, Governance, Capital, Credit risk, Market risk, HR etc. on case to case basis
Provisioning	♦ Provisioning / Impaired allowance is based on purely on expected credit loss and/or at fair value of the collateral if the loan is collateral dependent. ♦ Provisioning are even not needed when the value of the impaired loan is less than the collateral value. ♦ Residential mortgage loans in the fully-insured portfolio are not placed on nonaccrual status and, therefore never are reported as nonperforming ♦ Furthermore, the provisioning is not immediate after 90 days and only after 270 days the mortgage loan is provisioned for if the value of the collateral falls short.	♦ Gradual age wise provision for substandard assets starting from 15% In 1st year to 25%, 40% and 100% in subsequent years irrespective of whether collateral is available or not ♦ Higher provisions are must for unsecured substandard assets

CONCLUDING REMARKS

- We thus observe that minimum bank capital ratio required to be held under the Basel norms is only a floor and many countries including India requires their banks to hold capital at higher levels. In US higher leverage ratio also trigger higher capital requirements for systemically important and/or large banks as in July 2013, the U.S. Federal Reserve announced that the minimum Basel III leverage ratio would be 6% for 8 Systemically important financial institution (SIFI) banks and 5% for their insured bank holding companies.
- Further, Financial Accounting Standard Board (FASB) has issued a new accounting standard effective on January 1, 2020, with early adoption permitted on January 1, 2019, that will require the earlier recognition of credit losses on loans and other financial instruments based on an expected loss model, replacing the incurred loss model that is currently in use.
- Overall, we feel RBI PCA framework and provisioning requirements is more conservative and rule based as compared to FDIC as the capital triggers kicks in much prior i.e. below 10.875% as compared to FDIC 8%. We also feel being traditionally more conservative, helps in withstanding crisis, and early recognition of the problem entails timely corrective measure. However, whether a rule based or a discretion based approach works better remains a matter of empirical debate till date.

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ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management , corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

DISCLAIMER

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