RBI PCA Framework for NBFCs – No immediate impact

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Overview

As on March 31, 2021, the NBFC sector (including HFCs), had an asset size of over Rs.54 lakh crore across 12 categories and the sector currently stands at 25% of the size of the banks. RBI has been issuing a series of regulations including the Scale Based Regulations and Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances which are impacting the NBFC sector. Now RBI has introduced a PCA Framework to strengthen the supervisory tools applicable to NBFCs.

The PCA Framework for NBFCs would be effective beginning October 01, 2022; and be based on the financial position on or after March 31, 2022. This comes after NBFCs ran into trouble and RBI had to supersede the Board of Directors and appoint an administrator/Insolvency Resolution Professional[1].

CARE Ratings view

The PCA framework was initially introduced for banks in 2002 and was tightened a couple of times (RBI Issues Revised PCA Framework). The framework enables RBI to repair banks until their recovery. Currently, only the Central Bank of India remains under PCA framework.

A similar bank like PCA structure has been proposed for NBFCs for rebuilding the operations of an NBFC and / or undertaking actions under the IBC or winding up the operations of the NBFC. This regulation is a move to align NBFC regulations with the bank regulation especially for the larger NBFCs. Such a framework provides a position to enable NBFCs to pause and recover. Exiting from the PCA continues to remain at RBI's discretion. Additionally, the initial risk thresholds are also generally in line with the June 24, 2021, RBI circular on dividend pay-out by NBFCs (restriction on dividend distribution/remittance of profits pay-outs is a mandatory action for NBFCs entering the PCA framework even under the Risk Threshold 1).

As RBI's updated directions on Income Recognition, Asset Classification and Provisioning (IRACP) may result in an average increase of around 150 bps in Gross NPAs, being a proportion of assets moving from SMA2 buckets. This may also require additional provisioning to maintain comfortable NNPA levels.

The PCA framework is applicable from October 2022 and would cover the annual financials beginning with FY22 numbers. To counter the impact of three-four continuing years of multiple stress events including demonetisation, liquidity crisis, multiple covid waves, the NBFC sector has focussed strongly on persevering and enhancing capital buffers. Hence, the capital adequacy requirements to be excluded under this framework are well met by the non-bank lenders.

Some NBFCs, which have Net NPAs of over 6% in their currently quarterly numbers and hence could have potentially breached the net NPA criteria, have even otherwise expressed their keenness to focus on recovery and/ or write-offs vis a vis growth to move towards Net NPA of less than 6% in their annual numbers for FY22, with a long-term target of moving below 4%. Hence, we do not expect any NBFC within our rated universe to be impacted by this framework.

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[1] Initiate the process of resolution of the company under the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019

The NBFC PCA framework would be applicable to and would be reviewed after three years

- All deposit taking NBFCs, and,
- Non-deposit taking NBFCs in Middle, Upper and Top Layers

The following **segments** have been **excluded** from the framework

- **Government companies**[2],
- NBFCs in the base layer (i.e., **below Rs 1,000 crores** in size),
- NBFCs **not accepting**/not intending to accept **public funds**[3],
- **Primary dealers**, and,
- **Housing finance companies**.

Separate risk thresholds have been prescribed for NBFCs-D & NBFCs-ND, (key monitoring areas include capital and asset quality) and CICs (key monitoring areas include capital, leverage, and asset quality). The thresholds and corrective actions across thresholds have been mentioned below.

Figure 1: Thresholds for NBFCs-D and NBFCs-ND (excluding CICs):

Indicator	Risk Threshold-1	Risk Threshold-2	Risk Threshold-3
CRAR	Up to 300 bps below the regulatory minimum CRAR [currently, CRAR <15% but ≥12%]	More than 300 bps but up to 600 bps below regulatory minimum CRAR [currently, CRAR <12% but ≥9%]	More than 600 bps below regulatory minimum CRAR [currently, CRAR <9%]
Tier I Capital Ratio	Up to 200 bps below the regulatory minimum Tier I Capital Ratio [currently, Tier I Capital Ratio <10% but ≥8%]	More than 200 bps but up to 400 bps below the regulatory minimum Tier I Capital Ratio [currently, Tier I Capital Ratio <8% but ≥6%]	More than 400 bps below the regulatory minimum Tier I Capital Ratio [currently, Tier I Capital Ratio <6%]
NNPA Ratio (incl. NPIs)	>6% but ≤ 9%	>9% but ≤12%	>12%

Source: RBI

Figure 2: Thresholds for CICs:

Indicator	Risk Threshold-1	Risk Threshold-2	Risk Threshold-3
Adjusted Net Worth / Aggregate Risk Weighted Assets	Up to 600 bps below the regulatory minimum ANW/RWA [currently, ANW/RWA <30% but ≥24%]	More than 600 bps but up to 1,200 bps below regulatory minimum ANW/RWA [currently, ANW/RWA <24% but ≥18%]	More than 1,200 bps below the regulatory minimum ANW/RWA [currently, ANW/RWA <18%]
Leverage Ratio	≥2.5 times but <3 times	≥ 3 times but <3.5 times	≥3.5 times
NNPA Ratio (incl. NPIs)	>6% but ≤ 9%	>9% but ≤12%	>12%

Source: RBI

[2] Government NBFCs have time up to March 31, 2022, to adhere to the capital adequacy norms applicable for NBFCs. Hence, a separate circular would be issued about the applicability of PCA Framework to Government NBFCs.

[3] Public funds include funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 5 years from the date of issue.

Figure 3: Menu of corrective actions across thresholds

Mandatory and Discretionary actions		
Specifications	**Mandatory actions**	**Discretionary actions**
Risk Threshold 1	• Restriction on dividend distribution/remittance of profits. • Promoters/shareholders to infuse equity and reduction in leverage. • Restriction on issue of guarantees or taking on other contingent liabilities on behalf of group companies (only for CICs)	Common menu • Special Supervisory Actions • Strategy related • Governance related • Capital related • Credit risk related • Market risk related • HR related • Profitability related • Operations/Business related • Any other action that RBI may deem fit
Risk Threshold 2	In addition to mandatory actions of Threshold 1, • Restriction on branch expansion	
Risk Threshold 3	In addition to mandatory actions of Threshold 1 & 2, • Appropriate restrictions on capital expenditure, other than for technological upgradation within Board approved limits • Restrictions/ reduction in variable operating costs	

Source: RBI

Please refer to the following analytical publications on various topics mentioned in the note above

- RBI introduces Scale-based Regulations for NBFCs
- RBI IRACP Norms – Gross NPAs of many NBFCs likely to inch up
- RBI IRACP Norms – Impact across Asset Classes for NBFCs

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