Mind The Risk

The article is related to
General Studies-Paper-III
(Indian Economy)

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On Tuesday, the Reserve Bank of India (RBI) introduced a prompt corrective action (PCA) framework for non-banking finance companies (NBFCs). The framework has been designed to trigger supervisory intervention at the suitable time, helping nurse the entity back to health, and limit the fallout on the larger financial system.

Under it, certain parameters of NBFCs like bad loans and capital adequacy ratios will be monitored, and as and when these parameters fall below pre-defined levels, the central bank will impose restrictions on activities of NBFCs in varying degrees. The framework will be effective from October 2022, giving the NBFCs time to bolster their balance sheets which may have been impacted due to the economic fallout of the pandemic. With this step, the RBI is moving towards bringing about some alignment in the supervisory framework of NBFCs with that of banks.

Under the framework, the central bank has taken three indicators, namely, the capital to risk weighted assets ratio (CRAR), the tier I capital ratio and the net NPA ratio (NNPA) to delineate three risk thresholds. If an NBFC's position worsens on these parameters, then the entity will move higher on the risk profile. And as its risk profile deteriorates, the severity of the restrictions imposed by the RBI will increase. These begin with curbs on the distribution of dividend, restrictions on guarantees and taking on contingent liabilities of group companies, and requiring the promoters/shareholders to infuse equity in the entity and reduce leverage. At high risk thresholds, curbs will also be imposed on branch expansion, capital expenditure, and operating costs. Exit from the PCA framework and the easing of restrictions will be conditional upon the NBFC not breaching the risk thresholds for four continuous quarters.

With this segment growing in size — the NBFC credit to GDP ratio stood at 11.6 per cent in 2020 as per the RBI — and with strong linkages with the other parts of the financial system, their asset quality must be closely observed. More so for the larger deposit-taking NBFCs. A delay in taking action only complicates matters, adding to the uncertainty in financial markets. The collapse of NBFCs such as the Infrastructure Leasing & Financial Services (IL&FS) and Dewan Housing Finance Corporation Limited (DHFL), the fallout in the financial markets and the larger economy, the spectre of liquidity issues morphing into solvency issues, only underline the need for such a framework. Addressing the stress earlier lowers the associated costs.

Expected Question (Prelims Exams)

Q. Which of the following indicators have been prescribed by RBI recently to measure the risk of NBFCs?

(a) Risk Weighted Assets Ratio (CRAR)

(b) Tier 1 Capital Ratio

(c) Net NPA Ratio

(d) All of the above.

Expected Question (Mains Exams)

Q. What are the new guidelines recently made by RBI for NBFCs and how will this control of RBI prove to be better for the economy?

(250 Words)

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Note: - The question of the main examination given for practice is designed keeping in mind the upcoming UPSC main examination. Therefore, to get an answer to this question, you can take the help of this source as well as other sources related to this topic.