November 14, 2022(Revised)

Indian Overseas Bank: Rating upgraded to [ICRA]AA- (Stable) ; Outlook revised to Stable

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Tier II Bonds	300.00	300.00	[ICRA]AA- (Stable); Upgraded from [ICRA]A+ (Positive); outlook changed from positive to Stable
Basel III Tier II Bonds	800.00	-	[ICRA]AA- (Stable); Upgraded from [ICRA]A+ (Positive); outlook changed from positive to Stable and withdrawn
Total	**1,100.00**	**300.00**	

**Instrument details are provided in Annexure I*

Rationale

The rating upgrade factors in the improvement in Indian Overseas Bank's (IOB) solvency[1] profile, capital position and profitability, which, in our view, is likely to sustain going forward. The improvement was driven by the reduction in the legacy stressed assets, leading to lower credit costs and a consequent improvement in the core and net operating profitability.

The rating also considers IOB's sovereign ownership and the Government of India's (GoI) demonstrated track record of capital infusion into the bank. In this regard, the GoI had infused equity capital of Rs. 24,074 crore into the bank during FY2018-FY2022 through recapitalisation bonds, including Rs. 4,100 crore through zero coupon bonds (ZCBs) in March 2021. Further, the bank's deposit base remains stable with the improving share of core deposits supported by a well-established deposit franchise, which drives its strong liquidity profile.

The rating, however, factors in the asset quality stress because of the Covid-19 pandemic, which resulted in an elevated restructured and overdue due book in relation to the overall standard advances. Accordingly, the performance of the stressed book will remain a key monitorable for fresh slippages and profitability in the near term. However, given the high provision cover on legacy stressed assets and the consequent decline in the net non-performing advances (NNPAs), ICRA expects that the bank is likely to significantly absorb the incremental credit provisions from its operating profits. This will lead to limited capital dependence on the GoI, going forward.

ICRA has withdrawn the rating on IOB's Rs. 800.00-crore Basel III Tier II bonds programme as the same has been fully redeemed with no amount outstanding against the rated instrument. The rating has been withdrawn as per ICRA's policy on the withdrawal and suspension of credit ratings (click here for the policy).

Key rating drivers and their description

Credit strengths

Sovereign ownership with demonstrated capital support from GoI – IOB has majority sovereign ownership with the GoI's equity stake in the bank at 96.38% as of September 30, 2022. The GoI had infused equity capital of Rs. 24,074 crore into the bank during FY2018-FY2022 through recapitalisation bonds, including Rs. 4,100 crore through ZCBs[2] in March 2021. This enabled the bank to increase its provision cover on legacy stressed assets, while improving its capital ratios above the regulatory levels, and helped it exit the Reserve Bank of India's (RBI) prompt corrective action (PCA) framework in September 2021. Going forward, a sustained improvement in internal capital generation is likely to limit the near-term requirement for capital support from the

[1] Solvency ratio = Net stressed assets / Core capital; net stressed assets include NNPAs, net non-performing investments and net security receipts

[2] These ZCBs were issued at face value and are redeemable at face value after the 10-15th year from issuance; accordingly, the fair value is lower than the face value. IOB has accounted for these ZCBs at fair value from its March 2022 financials

GoI. Further, as a part of the Union Budget, the GoI had proposed the divestment of two public sector banks (PSBs). The rating will be reassessed in case of a change in the sovereign ownership.

Well-developed deposit franchise and strong liquidity position – IOB has a long-standing presence and an established retail franchise in South India with a total branch network of 3,214 as on June 30, 2022. While the branch network has been declining over the last few years as the bank has been shutting down loss-making branches, its deposit base has remained stable at Rs. 2.2-2.6 lakh crore over the last 4-5 years, given the limited credit growth due to its inclusion in the PCA framework. Further, with the steady growth in the low-cost current account and savings account (CASA) deposit base and the overall stability in the deposit base, the share of CASA deposits improved to 43.07% as on June 30, 2022 from 41.63% as on June 30, 2021 (26.3% as on December 31, 2015).

While the limited growth in the loan book (as the bank was in the PCA framework and had a weak capital position) helped IOB reduce its overall dependence on bulk deposits (declined to ~5% as on June 30, 2022 from ~21% as on March 31, 2019), an uptick in the overall growth amidst rising interest rates could lead to a relative increase in the share of bulk deposits from these levels while the cost of interest-bearing funds could also rise.

Improving capitalisation and solvency profile – Driven by the capital infusion by GOI in the past and the bank being profitable from the last ten consecutive quarters, IOB reported CET-I/Tier-I% and solvency ratio improved to 12.11% and 32.4%, respectively, as on September 30, 2022 from 12.84% and 38.1%, respectively, as on September 30, 2021 despite providing for the fair valuation of the ZCBs to the extent of Rs. 2,231 crore in FY2022. Given the high provision cover on legacy stressed assets and the decline in the NNPAs, ICRA expects that the internal capital generation is likely to be sufficient for growth as well as for maintaining adequate cushion over the regulatory capital requirements.

Credit challenges

Asset quality remains weak as slippages remain elevated – Following the onset of the pandemic, gross fresh slippages remained elevated at Rs. 5,031 crore (4.1% of standard advances) in FY2022 (2.8% in FY2021 and 6.1% in FY2020), although the same remained below the levels seen in recent years (6.11-13.94% during FY2018-FY2020). Despite the elevated slippages, the high provision coverage maintained by the bank on the existing stock of NPAs at 90.9% (including written-off accounts) as on September 30, 2022 kept the NNPA level at 2.56% as on September 30, 2022 (15.40% as on March 31, 2018).

Apart from the overdue loan accounts as indicated by SMA[3]-1 and SMA-2, the pandemic has resulted in a high level of standard restructured advances. While the overall stressed book (SMA-1 + SMA-2 + restructured + net non-performing investments + net security receipts) has moderated from the higher levels, the performance of the restructured and overdue loan book will remain a key driver of fresh slippages and profitability. Nevertheless, high provisions on legacy stressed assets remain a comfort and ICRA expects that IOB is better placed to absorb the incremental asset quality pressure in the coming years through its operating profit.

Earnings profile likely to remain average – Supported by the high growth in advances, the improving spreads in relation to past levels, and recoveries from written-off accounts, the bank's operating profit improved to 2.08% of average total assets (ATA) in H1 FY2023 (1.80% in FY2022). Furthermore, credit costs stood at 1.08% of ATA in H1 FY2023 against 1.20% in FY2022 and 1.49% in FY2021, supporting an improvement in the return metrics {return on assets (RoA)}, which stood at 0.60% in H1 FY2023 (0.60% in FY2022, 0.31% in FY2021). Going forward, the ability to keep the credit costs at lower levels will be key to sustain the improvement in internal capital generation.

Environmental and social risks

Environmental considerations – Given the service-oriented business of IOB, its direct exposure to environmental risks as well as those emanating from regulations or policy changes is not material. While the bank does not face material physical climate risks, it is exposed to environmental risks indirectly through its portfolio of assets. However, such risk is unlikely to be material

[3] Special mention accounts (SMA) are overdue loans with SMA-0 reflecting an overdue status of up to 30 days, SMA-1 reflecting an overdue status of 31-60 days and SMA-2 reflecting an overdue status of 61-90 days

because IOB benefits from portfolio diversification. Further, the lending is usually short-to-medium term, which allows the bank to adapt while taking incremental exposures on less environmentally vulnerable businesses.

Social considerations – Data security and customer privacy are among the key sources of vulnerability for IOB as any material lapse could be detrimental to its reputation and could invite regulatory censure. Customer preference is increasingly shifting towards digital banking, which provides an opportunity to reduce the operating costs. However, the possibility of sub-par execution of the information technology strategy, and thus the inability to adequately meet the customers' needs, could result in more costs than benefits.

On the positive side, IOB contributes towards enhancing financial inclusion by providing several products and services that are specifically targeted towards the marginalised sections of society and attempts to address and cater to social concerns. Prudent lending to such under-served segments could create growth opportunities. However, such growth opportunities must be seen in conjuncture with asset quality risks that could impact the bank's credit quality.

Liquidity position: Strong

IOB had excess statutory liquidity ratio (SLR) holdings of Rs. 23,374 crore {9.0% of net demand and time liabilities (NDTL)} as on June 17, 2022. This supported its strong liquidity coverage ratio (LCR), which stood at 169% for Q1 FY2023. Furthermore, the cumulative gaps as per the structural liquidity statement (SLS) as on September 20, 2022, up to the 1-year maturity buckets stood at 1.13% while the reported net stable funding ratio (NSFR) stood at 144% against the regulatory requirement of 100% in Q1 FY2023.

Given the stronger growth expected over the near to medium term, the excess SLR holdings are likely to decline, which will lead to the relative narrowing of the 1-year cumulative gaps, going forward. However, IOB can avail liquidity support from the RBI (through repo against excess SLR investments and the marginal standing facility mechanism) in case of urgent liquidity requirement. Moreover, supported by its sovereign ownership and deposit franchise, ICRA expects IOB to roll over its deposits upon maturity and maintain its liquidity profile.

Rating sensitivities

Positive factors – ICRA could revise the outlook to Positive and/or upgrade the rating if the bank is able to improve its profitability, with an RoA of >0.5%, coupled with an improvement in the solvency profile with net stressed assets/core equity improving to less than 30% on a sustained basis while maintaining Tier I cushions of >1% over the regulatory Tier I levels (including capital conservation buffers).

Negative factors – The rating will be reassessed in case of a change in the sovereign ownership. ICRA could also revise the outlook to Negative and/or downgrade the rating if the asset quality or capitalisation profile deteriorates, thereby weakening the solvency profile with net stressed assets/core equity exceeding 70% on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	ICRA's Rating Methodology for Banks Impact of Parent or Group Support on an Issuer's Credit Rating ICRA's Policy on Withdrawal of Ratings Rating approach – Consolidation
Parent/Group support	The rating factors in IOB's sovereign ownership and the demonstrated track record of capital infusions by the GoI. ICRA expects the GoI to support IOB with capital infusions, if required.
Consolidation/Standalone	To arrive at the rating, ICRA has considered the standalone financials of IOB. However, in line with ICRA's limited consolidation approach, the capital requirement of the bank's key subsidiaries has been factored in.

About the company

Established in 1937, IOB is a public sector bank (PSB) with the GoI holding an equity stake of 96.38% in the bank as on September 30, 2022 (95.84% as on March 31, 2020). As on June 30, 2022, the bank had a well-established network of 3,214 branches.

IOB reported a profit after tax of Rs. 894 crore in H1 FY2023 against a profit after tax of Rs. 703 crore in H1 FY2022. Its asset quality indicators, i.e. gross NPA (GNPA%) and NNPA%, stood at 8.53% and 2.56%, respectively, as on September 30, 2022 compared to 10.67% and 2.77%, respectively, as on September 30, 2021. The capitalisation metrics, i.e. CET-I/Tier-I and CRAR, stood at 12.11% and 15.14%, respectively, as on September 30, 2022, compared to 12.84% and 15.41%, respectively, as on September 30, 2021.

Key financial indicators (standalone)

Indian Overseas Bank	FY2021	FY2022	H1 FY2022	H1 FY2023
Net interest income	5,899	6,311	3,130	3,707
Profit before tax	840	1,714	717	902
Profit after tax	832	1,710	703	894
Net advances (Rs. lakh crore)	1.3	1.4	1.3	1.6
Total assets* (Rs. lakh crore)	2.7	3.0	2.8	3.0
CET-I/Tier-I	12.9%	10.7%	12.8%	12.1%
CRAR	15.3%	13.8%	15.4%	15.1%
Net interest margin / Average total assets	2.2%	2.2%	2.3%	2.5%^
Net profit / Average total assets	0.3%	0.6%	0.5%	0.6%^
Return on net worth	5.7%	8.4%	9.3%	8.6%^
Gross NPAs	11.7%	9.1%	10.7%	8.5%
Net NPAs	3.6%	2.4%	2.8%	2.6%
Provision coverage excl. technical write-offs	72.0%	75.2%	76.1%	71.8%
Net NPA / Core equity	31.7%	30.8%	25.8%	28.1%

**Total assets and net worth exclude revaluation reserves*
Source: IOB, ICRA Research; Amount in Rs. crore unless mentioned otherwise
^ Annualised
All calculations as per ICRA Research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2023)				Chronology of Rating History for the Past 3 Years				
		Type	Amount Rated	Amount Outstanding	Date & Rating in FY2023	Date & Rating in FY2022	Date & Rating in FY2021			Date & Rating in FY2020
			(Rs. crore)	(Rs. crore)	Nov-14-2022	Mar-14-22	Mar-16-21	Dec-29-20	Oct-12-20	Dec-20-19
1	Basel III Tier II Bonds	LT	300.00	300.00	[ICRA]AA- (Stable)	[ICRA]A+ (Positive)	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)
			800.00	800.00	[ICRA]AA- (Stable); withdrawn	[ICRA]A+ (Positive)	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)
			500.00	-	-	[ICRA]A+ (Positive); withdrawn	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	-	-
2	Basel II Lower Tier II Bonds	LT	-	-	-	-	[ICRA]A+ (Stable); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
3	Basel II Upper Tier II Bonds	LT	-	-	-	-	[ICRA]A- (Stable); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)
4	Certificate of Deposit	ST	-	-	-	-	-	-	[ICRA]A1+; withdrawn	[ICRA]A1+;

Complexity level of the rated instrument

Instrument	Complexity Indicator
Basel III Tier II Bonds	Highly Complex

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional or legal aspects. Details on the complexity levels of the instruments are available on ICRA's website: Click Here

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE565A09264	**Basel III Tier II Bonds**	Dec-10-18	11.70%	Dec-10-28^	300.00	[ICRA]AA- (Stable)
INE565A09256		Nov-03-16	9.24%	Nov-03-26@	800.00	[ICRA]AA- (Stable); Withdrawn

Source: Indian Overseas Bank

@Call option can be exercised by the bank at the end of 5 years (or on any coupon payment date thereafter) after approval from the RBI

^ Call option can be exercised by the bank at the end of 5 years (or on any coupon payment date thereafter) after approval from the RBI

Key features of rated debt instruments

The servicing of the Basel III Tier II bonds is not subject to any capital ratios and profitability. However, these bonds are expected to absorb losses once the point of non-viability (PONV) trigger is invoked. Further, the exercise of the call option on the Basel III Tier II bonds is contingent upon the prior approval of the RBI and the bank will also need to demonstrate that the capital position is well above the minimum regulatory requirement post the exercise of the said call option.

Annexure II: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
India International Bank (Malaysia)	35.00%	Limited Consolidation
Odisha Gramya Bank	35.00%	Limited Consolidation
Universal Sompo General Insurance	18.06%	Limited Consolidation

Source: Indian Overseas Bank, ICRA Research

Corrigendum

Rationale dated November 14, 2022, has been revised with changes as below:

Addition of "Rating Approach- Consolidation" in the analytical approach section

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