November 27, 2024

Indian Overseas Bank: Rating upgraded; 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	1,000.00	1,000.00	[ICRA]AA (Stable); Upgraded from [ICRA]AA- (Positive) and outlook revised to Stable from Positive
Total	**1,000.00**	**1,000.00**	

**Instrument details are provided in Annexure I*

Rationale

The upgrade in the long-term rating of Indian Overseas Bank (IOB) factors in the sustained improvement in its profitability, capital position and solvency[1] profile. This was driven by the reduction in legacy stressed assets along with the decline in the fresh non-performing advances (NPA) generation rate, leading to lower credit costs and a consequent improvement in the core and net operating profitability.

The rating continues to be supported by IOB's sovereign ownership and the Government of India's (GoI) demonstrated track record of capital infusion into the bank. The GoI had infused equity capital of Rs. 24,074 crore into the bank during FY2018-FY2022 through recapitalisation bonds. ICRA expects IOB to remain sufficiently capitalised with no need for regulatory or growth capital in the medium to near term. However, the impact of transitioning to loan loss provisioning, based on the expected credit loss (ECL) framework, on its capital and profitability levels will remain a monitorable. Further, the rating continues to factor in IOB's well-established deposit franchise with a strong current account and savings account (CASA) base, which also augments its strong liquidity profile, leading to a competitive cost of interest-bearing funds in relation to the public sector banks' (PSB) average.

The rating takes into consideration the steady improvement in the headline asset quality numbers and the continued moderation in the overall vulnerable/monitorable book (comprising SMA[2]-1, SMA-2 and the standard restructured book). However, the vulnerable book continues to be high in relation to the bank's core capital and would remain a monitorable in the backdrop of the persisting high interest rates, geopolitical issues, and concerns around overleveraging among retail borrowers. In addition, ICRA notes that the bank's profitability has been supported by the healthy recoveries from its stressed assets (including written-off accounts) and its ability to maintain the same, while keeping fresh NPA generation in check, would be key for profitability.

The Stable outlook on the rating factors in ICRA's expectation that IOB will be able to maintain a steady credit profile with healthy earnings while ensuring stable asset quality and strong capital cushions.

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 on September 30, 2024. The GoI had infused equity capital of Rs. 24,074 crore into the

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[1] Solvency ratio = Net stressed assets / Core capital; net stressed assets include net NPAs (NNPAs), net non-performing investments and net security receipts
[2] SMA is defined as a special mention account; SMA-1 accounts are overdue by 31-60 days while SMA-2 accounts are overdue by 61-90 days

bank during FY2018-FY2022 through recapitalisation bonds, including Rs. 4,100 crore in the form of zero coupon bonds (ZCBs[3]) in March 2021. This enabled it 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, IOB's ability to maintain healthy profitability metrics is likely to limit the near-term requirement of capital support from the GoI.

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 3,269 as on September 30, 2024 (3,280 in March 2019), although the same has not grown in the past five years. Its steady deposit base is supported by CASA deposits, which accounted for 42.44% of its overall deposits as on September 30, 2024 (43.65% as on September 30, 2023), remaining above the PSB average. Moreover, the bank's cost of interest-bearing funds (annualised) was 5.05% in Q1 FY2025 against the PSB average of 5.15%. Given the credit-to-deposit ratio of 74.1% as on September 30, 2024, IOB's deposit growth requirements are likely to remain comfortable for incremental credit growth, which stood at 10.2% YoY as on September 30, 2024.

Besides the high share of CASA deposits, the share of the top 20 depositors in total deposits remained low at 4.48% as on March 31, 2024. The granular deposit base and the high share of CASA deposits continue to strengthen the bank's resource and liquidity profile.

Strong capitalisation and solvency profile – The bank's core equity capital (CET I)/Tier I witnessed a sustained improvement and stood at 14.75%[4] as on September 30, 2024 vis-à-vis 13.81% as on September 30, 2023 (12.11% as on September 30, 2022). While the capitalisation profile was supported by infusions in the past, IOB remained profitable during FY2021-H1 FY2025, leading to healthy internal capital generation. With the rise in the provision coverage ratio (PCR) on stressed assets and the increase in the CET on account of the improvement in internal capital generation, the solvency level improved to 4.75% as on September 30, 2024 from 7.5% as on September 30, 2023 (32.4% as on September 30, 2022). Given the high provision cover on legacy stressed assets and the decline in the net NPAs (NNPAs), ICRA expects that the internal capital generation is likely to be sufficient for growth as well as for maintaining strong cushions over the regulatory capital requirements.

Notwithstanding the sufficient internal accruals and capital position for growth, the RBI's implementation of the expected credit loss (ECL) framework for credit exposures remains monitorable for the capital position.

Earnings profile improves – Lower interest reversals due to better asset quality levels as well as the improvement in the credit-to-deposit ratio led to the healthy operating profitability of 1.95% of average total assets (ATA) in H1 FY2025 (1.96% in FY2024). The operating profitability was also supported by strong recoveries from written-off accounts. While the bank continues to maintain a healthy PCR on stressed assets and has also built up strong standard asset provisions, over and above the regulatory levels, credit cost was lower in H1 FY2025 and FY2024 than the high levels witnessed in the past. Accordingly, IOB reported heathy return metrics {return on assets (RoA)} of 0.78% in H1 FY2025 (0.80% in FY2024, 0.69% in FY2023). With legacy NPAs largely provided for, ICRA expects the profitability to remain healthy on the back of low credit costs due to better asset quality.

Credit challenges

Asset quality remains monitorable – The annualised fresh NPA generation rate moderated to 0.55% of standard advances in H1 FY2025 from the much higher levels in the past (0.94% in FY2024, 3.19% in FY2023, 4.09% in FY2022). Apart from this, healthy recoveries/upgrades and significant write-offs in FY2024 and H1 FY2025 supported the decline in the gross NPA (GNPA) level to 2.72% as on September 30, 2024 from 4.74% as on September 30, 2023. Moreover, the bank's healthy PCR of 83.1% (excluding written-off accounts) as on September 30, 2024 as well as loan book growth led to an improvement in the NNPA level to 0.47% from 0.68% during this period.

Even though the vulnerable book has moderated from the high levels witnessed in the past, it remains elevated in relation to the bank's core capital. Hence, IOB's ability to limit slippages from this book will remain a near-to-medium-term monitorable.

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[3] 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
[4] Including interim profits

In addition, the persisting high interest rates, geopolitical issues, and concerns around overleveraging among retail borrowers could impact the asset quality metrics adversely.

Environmental and social risks

While banks like IOB do not face material physical climate risks, they are exposed to environmental risks indirectly through their portfolio of assets. If the entities or businesses, to which banks and financial institutions have an exposure, face business disruptions because of physical climate adversities or if such businesses face climate transition risks because of technological, regulatory or customer behaviour changes, it could translate into credit risks for banks. However, such risk is not material for IOB as it benefits from adequate portfolio diversification. Further, the lending is typically short-to-medium term, allowing it to adapt and take incremental exposure to businesses that face relatively fewer downside environmental risks.

With regards to social risks, data security and customer privacy are among the key sources of vulnerability for banks as material lapses could be detrimental to their reputation and invite regulatory censure. IOB has not faced material lapses over the years. Customer preferences are increasingly shifting towards digital banking, which provides an opportunity to reduce the operating costs. IOB has been making the requisite investments to enhance its digital interface with its customers. While it contributes to promoting financial inclusion by lending to the underserved segments, its lending practices remain prudent as reflected in the healthy asset quality numbers in this segment compared with its peers.

Liquidity position: Strong

IOB's liquidity profile is strong, supported by its strong retail liability franchise. Moreover, the liquidity coverage ratio remained comfortable at 125.8% and the net stable funding ratio was 133.5% for the quarter ending September 30, 2024 against the regulatory requirement of 100%. Further, the bank can avail liquidity support from the RBI (through repo against excess statutory liquidity ratio (SLR) investments and marginal standing facility mechanism) in case of urgent liquidity needs. Supported by its sovereign ownership, healthy liabilities profile and excess SLR holdings, ICRA expects IOB to continue maintaining a strong liquidity profile.

Rating sensitivities

Positive factors – IOB's ability to increase its scale of operations meaningfully, while maintaining healthy profitability, a comfortable solvency profile, and cushions of more than 2% over the regulatory Tier I levels (including capital conservation buffers), will be a positive factor.

Negative factors – The rating will be reassessed in case of a change in the sovereign ownership. ICRA could also revise the outlook or downgrade the rating if the asset quality or capitalisation profile deteriorates, thereby weakening the solvency profile with net stressed assets/core equity exceeding 30% on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	ICRA's Rating Methodology for Banks and Financial Institutions 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 the bank with capital infusions, if required.
Consolidation/Standalone	For arriving at the rating, ICRA has considered the standalone financials of IOB. However, in line with ICRA's consolidation approach, the standalone assessment of the bank factors in the ordinary and extraordinary support that it is expected to extend to its subsidiaries.

About the company

Established in 1937, IOB is a public sector bank (PSB) with the GoI holding an equity stake of 96.38% as on September 30, 2024. As on September 30, 2024, the bank had a well-established network of 3,269 branches.

IOB reported a profit after tax of Rs. 1,410 crore in H1 FY2025 compared to Rs. 1,125 crore in H1 FY2024. Its asset quality indicators, i.e. gross NPA (GNPA) and net NPA (NNPA), stood at 2.72% and 0.47%, respectively, as on September 30, 2024 compared to 4.74% and 0.68%, respectively, as on September 30, 2023. The capitalisation metrics, i.e. CET I/Tier I and CRAR, stood at 14.75% and 17.45%, respectively, as on September 30, 2024, compared to 13.81% and 17.00%, respectively, as on September 30, 2023.

Key financial indicators (standalone)

Indian Overseas Bank	FY2023	FY2024	H1 FY2025
Total income	12,720	15,178	7,356
Profit after tax	2,099	2,656	1,410
Total assets* (Rs. lakh crore)	3.11	3.49	3.74
CET I	12.88%	14.47%	14.75%*
CRAR	16.1%	17.28%	17.45%*
PAT / ATA	0.7%	0.80%	0.78%^
Gross NPAs	7.44%	3.10%	2.72%
Net NPAs	1.83%	0.57%	0.47%

Total assets and net worth exclude revaluation reserves
Source: IOB, ICRA Research; Amount in Rs. crore unless mentioned otherwise
Total income includes net interest income and non-interest income (excluding trading profit)
^ Annualised
**Including H1 profit*
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 (FY2025)				Chronology of Rating History for the Past 3 Years				
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating in FY2025	Date & Rating in FY2024		Date & Rating in FY2023		Date & Rating in FY2022
					Nov-27-2024	Jan-03-2024	Nov-28-2023	Nov-30-2022	Nov-14-2022	Mar-14-2022
1	Basel III Tier II Bonds	Long term	-	-	-	[ICRA]AA- (Positive); withdrawn	[ICRA]AA- (Positive)	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Positive)
			-	-	-	-	-	-	[ICRA]AA- (Stable); withdrawn	[ICRA]A+ (Positive)
			-	-	-	-	-	-	-	[ICRA]A+ (Positive); withdrawn
			1,000.00	1,000.00	[ICRA]AA (Stable)	[ICRA]AA- (Positive)	[ICRA]AA- (Positive)	[ICRA]AA- (Stable)	-	-

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
INE565A08050	**Basel III Tier II Bonds**	Mar-24-2023	9.00%	Mar-24-2033	1,000.00	[ICRA]AA (Stable)

Source: Indian Overseas Bank

^ Call option can be exercised by the bank at the end of five years after approval from the RBI

Key features of rated debt instrument

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 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%	Full Consolidation
Odisha Gramya Bank	35.00%	Full Consolidation
Universal Sompo General Insurance	18.06%	Full Consolidation

Source: Indian Overseas Bank, ICRA Research

** As on September 30, 2024*

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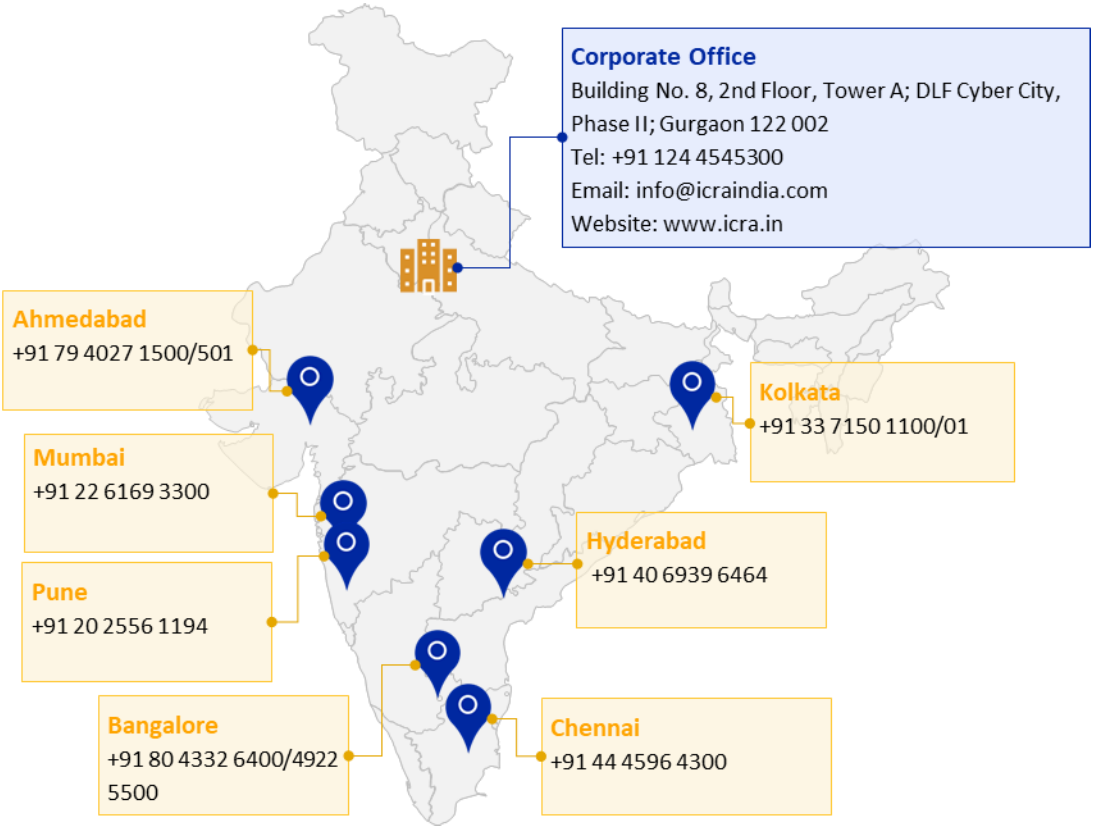

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