March 20, 2017

Union Bank of India

Instrument*	Rated Amount (Rs. crore)	Rating Action
Lower Tier II Bonds – Basel II	800	[ICRA]AA+(stable); reaffirmed
Basel II Compliant Innovative Perpetual Debt instruments	400	[ICRA]AA(stable); reaffirmed

*Instrument details are provided in Annexure-1

Rating Action

ICRA has reaffirmed the rating of [ICRA]AA+ (pronounced ICRA double A plus) for the Rs. 800 crore Lower Tier II Bonds and the rating of [ICRA]AA (pronounced ICRA double A) for Rs. 400 crore Basel II Compliant Innovative Perpetual Debt Instruments of Union Bank of India (Union Bank)[1]. The outlook on the ratings is stable.

The one notch lower rating of the Basel II Compliant Perpetual Bonds as compared with the rating of the Lower Tier II Bonds of the bank reflects the specific features of these instruments wherein the debt servicing is additionally linked to meeting the regulatory norms on capitalisation and reported profitability. The norms for hybrid debt capital instruments require regulatory approvals from the Reserve Bank of India (RBI) for debt servicing (including principal repayments) if the bank were to report a loss and are not liable to service the debt if the bank breaches the minimum regulatory capitalisation norms.

Rationale

The ratings continue to factor in the adequate and timely support expected from the Government of India (GoI) given the Union Bank's majority sovereign ownership (GoI holding of 63.44% as on December 31, 2016). The ratings also take note of the bank's established track record of more than 95 years with a strong franchise of over 4,000 branches and large pan-India network reflected in the adequate CASA deposit base (~37% of total deposits as on December 31, 2016, increased from 31% as on December 31, 2015). The ratings also factor in current capitalisation ratios (CRAR 11.36%, Tier I 8.51% and CET I 7.83% as on December 31, 2016 as against regulatory requirements of 10.25%, 8.25% and 6.75% respectively as on March 31, 2017) which are better when compared with other public sector banks.

The ratings, however, are constrained by Union Bank's weak asset quality, which continued to deteriorate after the RBI's asset quality review (AQR) during Q3FY2016. The bank's solvency indicators are also consequently weak. Fresh NPA generation remained high till Q3FY2017 and provision coverage remained low at ~51% (including technical write-offs) as on December 31, 2016. The bank's gross and net NPAs were high at 11.70% and 6.95% respectively as on December 31, 2016 increasing from 6.12% and 3.39% as on March 31, 2016; the NPA levels are similar to public sector banks' average. While the bank reported profits in 9MFY2017, the profits were supported by large gains on debt investment portfolio amid declining yields. With the credit costs consistently being higher than operating profits for the five quarters following the AQR, and the limited resolution in stressed assets and low provision coverage, the profitability in FY2018 will be under stress (in absence of treasury gains).

The bank's current capitalisation, though expected to meet the increased minimum regulatory capital levels as on March 31, 2017, remains low as compared with similar rated peer banks. Assuming a growth of ~10% in risk weighted assets (RWA) during FY2017-19 and a buffer of 0.5% over regulatory capital requirements, ICRA estimates a total Tier – I capital requirement of around ~Rs. 8500-9,000 crore (about

[1] For complete rating scale and definitions, please refer to ICRA's website (www.icra.in) or other ICRA rating publications

80-85% of its current market capitalisation) to meet the increased minimum regulatory capital levels under Basel III for FY2019. However, with the GoI shareholding of 63%, the ability of the bank to raise external capital while maintaining a majority GoI is relatively modest. Union Bank was allocated Rs. 721 crore of capital for FY2017 under the GoI's *"Indradhanush"* programme for recapitalisation of banks; however, the bank is yet to receive the capital. Going forward, the bank's ability to resolve the stressed assets, reduce further slippages, improve profitability and raise capital to support its capitalisation would be the key rating monitorables.

Credit Strengths

- Majority sovereign ownership at ~63%; ICRA expects GoI to support the bank in case of capital requirements
- Large distribution network of over 4,000 branches across India, with wide market reach in the rural and semi-urban areas
- Well developed deposit franchise with high CASA deposits (36.8% as on December 31, 2016 as compared with 30.6% as on December 31, 2015)
- Better capitalisation ratios (CRAR 11.36% and Tier I 8.51% as on December 31, 2016) as compared with other public sector banks; however, lower than similar rated peer banks

Credit Challenges

- Weak asset quality on account of high slippages over the last 12-15 months resulting in a deterioration in solvency indicators (net NPA/net worth of 87.90% as on December 31, 2016 as against 40.1% as on September 30, 2015)
- Credit costs consistently higher than core operating profits (excluding trading profits) for the last five quarters since the AQR exercise; profitability likely to remain weak during FY2018 in the absence of trading profits and limited resolution in stressed accounts
- Capital cushion not significant with Tier I at 8.51% levels as on December 31, 2016. With GoI shareholding of 63%, the bank's ability to raise external capital while maintaining majority GoI holding is restricted

Description of key rating drivers highlighted above:

The bank's loan book stood at Rs. 277,725 crore as on March 31, 2016 as compared with Rs. 262,757 crore as on March 31, 2015, registering a growth of ~19% (12% in FY2015). The total advances remained flat at Rs. 277,012 crore as on December 31, 2016 as incremental lending to corporate sector remained limited and the share of advances to corporates declined to 51% as on December 31, 2016 from 59% as on March 31, 2014. With a steady growth in advances to retail, agriculture and MSME segments, the share of these segments taken together increased from ~44% as on March 31, 2014 to ~55% as on December 31, 2016. Union Bank has an extensive network of over 4000 branches, spread across India, which provides it access to low cost savings and current deposits. Consequently, the bank had a high CASA base of 36.8% as on December 31, 2016 (30.6% as on December 31, 2015). With limited credit growth and a steady growth in CASA deposits, the high cost deposits reduced from 1.3% of overall deposits as on December 31, 2015 to 0.8% as on December 31, 2016.

The bank's slippages increased during FY2016 (of Rs. 12,953 crore) and 9MFY2017 (of Rs. 10,293 crore) after the AQR exercise directed by RBI in H2FY2016 and the subsequent slippages from weak accounts during 9MFY2017. Since these slippages were only partly offset by recoveries, upgradations and write-offs (amounting to Rs. 1,814 crore in FY2016 and Rs. 2,061 crore in 9MFY2017), Union Bank's asset quality indicators deteriorated as reflected by gross and net NPAs of 11.70% and 6.95% as on December 31, 2016 respectively as against gross and net NPAs of 4.96% and 2.71% respectively as on March 31, 2015. The asset quality numbers, though similar to public sector banks average, are weak.

With increasing slippages, the bank's provision coverage ratio declined to 50.62% as on December 31, 2016 from 55.00% as on December 31, 2015, which is likely to result in a pressure on future profitably unless a resolution is reached on stressed accounts. Going ahead, Union Bank's ability to control fresh NPA generation and ensure timely recovery from stressed advances would be important to improve its asset quality profile going forward and would be a key rating sensitivity.

Union Bank's regulatory capital adequacy stood at 11.36% (Tier I of 8.51% and CET I of 7.83%) under Basel III norms as on December 31, 2016 against the minimum regulatory requirement of 10.25% CRAR and Tier I of 8.25% and CET 1 of 6.75% respectively as on March 31, 2017. While Union Bank's capitalisation ratios are better than those of other public sector banks, the capital cushion is not significant. Assuming an RWA growth of ~10% during FY2017-19 and a buffer of 0.5% over regulatory capital requirements, ICRA estimates a total capital requirement of around ~Rs. 8,500-9,000 crore (about 85-90% of its current market capitalisation). In July 2016, GoI had announced a capital infusion of Rs. 721 crore for Union Bank; the bank is in advanced stages of receiving 75% of the above amount. However, with a GoI shareholding of ~63% as on December 31, 2016, the bank's ability to raise external equity is restricted. Timely equity support from GoI, as required, would continue to remain a key driver of Union Bank's credit profile.

Higher than expected slippage in the bank's asset quality, subdued credit growth and reversal of interest income on slipped accounts led to a significant dilution in its earnings in FY2016 and 9MFY2017. Additionally, sizeable net NPAs (6.95% as on December 31, 2016) and other weak assets are likely to keep credit costs elevated over the medium term, leading to a pressure on earnings and internal capital generation. While the bank has reported net profits in 9MFY2017, excluding the trading profits during this period, the loss (before tax) stands at Rs. 731 crore. With credit costs consistently higher than operating profits for the last five quarters since the AQR exercise, limited resolution in stressed assets and low provision coverage, there is a possibility of losses in FY2018 as the treasury gains main not sustain.

Analytical approach:
The ratings for Union Bank of India derive significant support from its GoI parentage and any change in the support could warrant a rating change for the entity.

Links to applicable Criteria
ICRA Rating Methodology for Banks

Company Profile
Majority owned by the GoI (63.44% as on December 31, 2016), Union Bank of India (Union Bank) is a large commercial banks in the country with an asset base of Rs. 4.50 lakh crore as on December 31, 2016. Union Bank has a network of 4,233 domestic branches and 7,496 ATMs as on December 31, 2016. For FY2016, Union Bank reported a net interest income of Rs. 8,313 crore and PAT of Rs. 1,352 crore vis-a-vis Rs. 8,444 crore and Rs. 1,782 crore for FY2015 respectively. During 9MFY2017, the bank reported a net interest income of Rs. 6,516 crore and net profit of Rs. 447 crore. The bank's gross and net NPAs stood at elevated levels of 11.70% and 6.95% respectively as on December 31, 2016, increasing from 6.12% and 3.39% as on March 31, 2016. The regulatory capital adequacy ratio under Basel III stood at 11.36% (Tier I – 8.51%, CET I – 7.68%) as on December 31, 2016.

Recent Results

For Q3FY2017 and 9MFY2017 bank reported net profits of Rs. 104 crore and Rs. 447 crore respectively on an asset base[2] of Rs. 4.50 lakh crore as on December 31, 2016 as compared with net profits of Rs. 78 crore and Rs. 1,255 crore during Q3FY2016 and 9MFY2016 respectively on an asset base of Rs. 3.89 lakh crore as on December 31, 2015.

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

Rating History for last three years:

Table: Rating History

Sr. No.	Name of Instrument	Current Rating			Chronology of Rating History for the past 3 years		
		Type	Rated Amount (Rs. crore)	March 2017	FY2016		FY2014
					February 2016	April 2015	March 2014
1	Lower Tier II Bonds	Long Term	800.00	[ICRA]AA+ (stable)	[ICRA]AA+ (stable)	[ICRA]AA+ (stable)	[ICRA]AA+ (stable)
2	Basel II Complaint Innovative Perpetual Debt Instruments	Long Term	400.00	[ICRA]AA (stable)	[ICRA]AA (stable)	[ICRA]AA (stable)	[ICRA]AA (stable)
3	Certificate of Deposits Programme	Short Term	-	-	-	[ICRA]A1+; withdrawn	[ICRA]A1+

Complexity level of the rated instrument:

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

[2] net of revaluation reserve and accumulated losses

Annexure-1
Details of Instrument

Name of the Instrument	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Current Rating and Outlook
Lower Tier II Bonds	17-Sep-2008	10.95%	16-Sep-2018	400.00	[ICRA]AA+(stable)
Lower Tier II Bonds	23-Dec-2008	9.50%	22-Dec-2018	200.00	[ICRA]AA+(stable)
Lower Tier II Bonds	30-Dec-2008	8.60%	29-Dec-2018	200.00	[ICRA]AA+(stable)
Basel II Complaint Innovative Perpetual Debt Instrument	12-Dec-2007	9.90% (Step up to 10.40% after 10 years)	Perpetual (Call: 12-Dec-2017)	200.00	[ICRA]AA(stable)
Basel II Complaint Innovative Perpetual Debt Instrument	09-Sep-2008	11.15% (Step up to 11.65% after 10 years)	Perpetual (Call: 09-Sep-2018)	200.00	[ICRA]AA(stable)

Source: Union Bank of India

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