Union Bank of India

April 30, 2018

Summary of rated instruments

Instrument	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Certificate of deposits	10,000.00	10,000.00	[ICRA]A1+; reaffirmed
Lower Tier II Bonds – Basel II	800.00	800.00	[ICRA]AA+(Stable); reaffirmed
Basel II Compliant Innovative Perpetual Debt instruments	200.00	200.00	[ICRA]AA (stable); reaffirmed
Basel II Compliant Innovative Perpetual Debt instrument	200.00	-	[ICRA]AA (Stable); withdrawn
Total	**11,200.00**	**11,000.00**	

Rating action

ICRA has reaffirmed the rating of [ICRA]A1+ (pronounced ICRA A one plus) for the Rs. 10,000.00-crore certificate of deposits programme of Union Bank of India (Union Bank)[1]. ICRA also reaffirmed the rating of [ICRA]AA+ (pronounced ICRA double A plus) for the Rs. 800.00-crore lower Tier II bonds programme and [ICRA]AA (pronounced ICRA double A) for the Rs. 200.00-crore of the Basel II compliant innovative perpetual debt instrument of Union Bank. The outlook on the long-term ratings is Stable.

ICRA has also withdrawn the rating of [ICRA]AA for the Rs. 200.00-crore Basel II compliant innovative perpetual debt instrument of Union Bank. Since there is no amount outstanding against the rated instrument, the rating has been withdrawn.

Rationale

The ratings for Union Bank are supported by its majority sovereign ownership (Government of India – GoI shareholding of 67.43% as on March 31, 2018) and its position as the sixth-largest public sector bank (PSB) with a 3.7% share in banking sector advances and 3.7% share in domestic bank deposits as on December 31, 2017. During FY2018, Union Bank raised additional equity of Rs. 6,524 crore (Rs. 2,000 crore via QIP and Rs. 4,524 crore from the GOI), which, in ICRA's estimates, is likely to exceed the losses that the bank is expected to report in FY2018 (loss before tax of Rs. 2,863 crore in 9M FY2018). Accordingly, the capitalisation ratios are likely to be better than previously reported levels as on December 31, 2017 (CRAR of 11.37%, Tier I of 8.65% and CET I of 7.18%) and March 31, 2017 (CRAR of 11.79%, Tier I of 9.02% and CET I of 7.71%). The ratings, however, are constrained by the bank's weak asset quality, which is expected to deteriorate further in the near term despite an increase in its gross non-performing advances (GNPAs) and net NPAs to 13.04% and 6.96%, respectively, as on December 31, 2017 from 11.17% and 6.57%, respectively, as on March 31, 2017. Further, with recent regulatory changes whereby the Reserve Bank of India (RBI) has discontinued all the earlier schemes for the resolution of stressed assets, ICRA expects the bank's slippages and credit provisions to surge during the next few

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

quarters given the stock of stressed assets[2] as on December 31, 2017, thereby keeping asset quality and profitability under pressure. High levels of net NPAs also translate into a weak solvency profile for the bank with net NPA/net worth of 96% as on December 31, 2017, which is expected to improve post the recapitalisation during Q4 FY2018. The high level of net NPAs may also trigger the possibility of the inclusion of Union Bank in the RBI's prompt corrective action (PCA) framework, which may constrain its growth.

Going forward, ICRA expects the bank's internal capital generation to remain weak during FY2019 and to be driven by the extent of haircuts in the existing and likely stressed accounts undergoing resolution. This will also determine the bank's incremental capital requirements and ability to raise sufficient capital to offset the expected losses and maintain capital cushions above regulatory levels, which will be a rating sensitivity. Though the bank is not in the RBI's PCA framework at present, subsequent inclusion may require the bank to recall its additional Tier-I (AT-I) bonds, thereby posing pressure on growth and increasing its capital requirements. This will be a rating negative.

Outlook: Stable

ICRA expects Union Bank to maintain sufficient capital cushion over regulatory levels as on March 2018. The outlook may be revised to Negative in case of deterioration in the asset quality over and above the identified stressed book and inability to raise sufficient capital to offset losses, if any. Also, as highlighted earlier, inclusion in the PCA framework will be a rating negative for the bank.

Key rating drivers

Credit strengths

Sovereign ownership with demonstrated capital support from GoI - The ratings continue to factor in the bank's majority sovereign ownership (67.43% equity shares held by the GoI as on March 31, 2018) and demonstrated capital infusions from the parent (Rs. 721 crore in FY2017 and Rs. 4,524 crore in FY2018) to support the capitalisation position while achieving growth. Union Bank's regulatory capital adequacy stood at 11.37% (Tier I of 8.65% and CET I of 7.18%) under Basel III norms as on December 31, 2017 against the minimum regulatory requirement of 10.875% CRAR, Tier I of 8.875% and CET I of 7.375% as on March 31, 2018. ICRA estimates that the capital infusion during FY2018 is likely to exceed the losses that the bank is expected to report in FY2018 (loss before tax of Rs. 2,863 crore in 9M FY2018). Accordingly, the capitalisation ratios are likely to be better than the previously reported levels as on December 31, 2017 and March 31, 2017. Ability to raise sufficient capital to offset the expected losses and maintain capital cushion above regulatory levels will be a rating sensitivity.

Large distribution network and sixth-largest PSB - Union Bank has an extensive network of over 4,298 domestic branches, out of which ~59% are in the rural and semi-urban region, providing access to low cost savings and current account deposits (CASA). The bank had a satisfactory CASA base of 34.0% as on December 31, 2017, which is slightly below the PSB average of 37.5%. The cost of interest-bearing funds for Union Bank was marginally higher at 5.4% for 9M FY2018 compared to the PSB average of 5.2%.

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[2] *The bank had a special mention account 2 (SMA-2) totalling ~5% of standard advances as on December 31, 2017, which largely included loans under regulatory forbearance schemes like Strategic Debt Restructuring - SDR, flexible restructuring and the scheme for sustainable structuring of stressed assets (S4A), all of which stand discontinued*

Focus on retail, agriculture and MSME segments - The bank's loan book stood at Rs. 301,684 crore as on March 31, 2017 compared to Rs. 277,725 crore as on March 31, 2016, registering a growth of ~9% (6% in FY2016). As on December 31, 2017, total advances grew by 6% (annualised) to Rs. 314,474 crore. Incremental lending to the corporate sector remained low compared to growth in advances to the retail, agriculture and MSME segments (RAM). The aggregate share of the RAM segments increased to ~55% as on December 31, 2017 from ~51% as on March 31, 2016. Focus on the RAM segments is expected to facilitate the bank's efforts to make its loan book more granular and diversified.

Credit challenges

Weak asset quality with the same expected to deteriorate further in near term - The bank's fresh slippages increased during FY2017 (Rs. 13,244 crore) and 9M FY2018 (Rs. 11,326 crore). Since these slippages were only partly offset by recoveries, upgradations and write-offs (amounting to Rs. 3,702 crore in FY2017 and Rs. 4,050 crore in 9M FY2018), the bank's asset quality indicators deteriorated as reflected by gross and net NPAs of 13.04% and 6.96% as on December 31, 2017, respectively, as against gross and net NPAs of 11.17% and 6.57%, respectively, as on March 31, 2017 and 8.71% and 5.25%, respectively, as on March 31, 2016. In addition, Union Bank has SMA-2 exposures (~5% of standard advances as on December 31, 2017) that largely include exposures under various restructuring schemes. With the recent revision in the RBI's guidelines for the resolution of stressed assets, a major portion of these can slip to NPAs in the near term. Union Bank had advances of Rs. 12,466 crore undergoing resolution under the Insolvency and Bankruptcy Code (IBC), 2016 with a provision of 55% on these accounts as on December 31, 2017. With an expected increase in slippages, the reported asset quality numbers are likely to deteriorate over the next few quarters. Subsequently, upon resolution, though the asset quality numbers may start improving, the extent of haircuts upon resolution may be a key determinant of credit provisions.

E**levated credit provisioning results in losses, near-term profitability to remain weak** - Net interest margins (NIMs), as % of average total assets (ATA), remained satisfactory at 2.09% and 2.06% during FY2017 and 9M FY2018, respectively (as against PSB average of 2.14% and 2.12%, respectively). However, core PBT (after provisions) was impacted by increasing credit costs. Credit cost is increasing continuously to 2.27% of ATA in 9M FY2018 from 1.46% in FY2017 and 1.19% in FY2016. With the softening of the market yield during FY2017 and H1 FY2018 and consequent gains on the investment book, the bank was able to offset a large proportion of its credit losses. However, with the firming of the bond yield during Q3 FY2018, the bank suffered mark-to-market provisions of Rs. 700 crore in Q3 FY2018. The bank posted a net loss of Rs. 2,664 crore during 9M FY2018 compared to a net profit of Rs. 555 crore in FY2017 and a net profit of Rs. 447 crore in 9M FY2017. ICRA expects that the credit provisions are likely to remain above the bank's pre-provisioning operating profits during FY2019, thereby keeping internal capital generation under pressure.

Inclusion in PCA framework may pose growth pressure and increase capital requirements - With net NPAs remaining consistently above the PCA-inclusion threshold of 6%, the risk of the bank being included in the PCA framework is likely to continue in the near term. Given that inclusion in the PCA framework has been defined as a regulatory event by some PSBs, thereby leading to the early recall of their AT-I bonds, this event remains critical for Union Bank considering AT-I bonds are estimated to be ~1.5% of its risk weighted assets (RWA) as on December 31, 2017. If the bank is included in the PCA framework, its capital position may weaken and growth may be curtailed - this will be a rating negative.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below.

Links to applicable criteria:

ICRA Rating Methodology for Banks

About the company:

Majority owned by the GoI (67.43% as on March 31, 2018), Union Bank of India (Union Bank) is a large commercial bank in the country with an asset base of Rs. 4.70 lakh crore as on December 31, 2017. Union Bank had a network of 4,298 domestic branches and 7,690 ATMs as on December 31, 2017. For FY2017, Union Bank reported net interest income of Rs. 8,903 crore and PAT of Rs. 555 crore vis-à-vis Rs. 8,314 crore and Rs. 1,352 crore for FY2016, respectively.

During 9M FY2018, the bank reported net interest income of Rs. 7,112 crore and net loss of Rs. 2,664 crore. The bank's gross and net NPAs stood at elevated levels of 13.04% and 6.96%, respectively, as on December 31, 2017, increasing from 11.17% and 6.57% as on March 31, 2017. The regulatory capital adequacy ratio under Basel III stood at 11.37% (Tier I – 8.65%, CET I – 7.18%) as on December 31, 2017.

Key financial indicators - (standalone)

	FY2016	FY2017	9MFY2017	9MFY2018
Net interest income	8,314	8,903	6,516	7,112
Profit before tax	1,765	343	653	(2,863)
Profit after tax	1,352	555	447	(2,664)
Net advances	267,354	286,467	262,659	293,669
Total assets	402,115	450,123	449,721	472,478
% CET	7.95%	7.71%	7.68%	7.18%
% Tier 1	8.14%	9.02%	8.51%	8.65%
% CRAR	10.56%	11.79%	11.36%	11.37%
% Net interest margin / Average total assets	2.13%	2.09%	2.04%	2.06%
% Net profit / Average total assets	0.35%	0.13%	0.14%	(0.77%)
% Return on net worth	6.99%	2.66%	2.90%	(16.66%)
% Gross NPAs	8.71%	11.17%	11.71%	13.04%
% Net NPAs	5.25%	6.57%	6.95%	6.96%
% Provision coverage excl. technical write offs	41.97%	44.14%	43.69%	50.16%
% Net NPA/ Net worth	69.06%	88.02%	87.90%	96.15%

Amount in Rs. crore

Source: Union Bank; ICRA research

All ratios are as per ICRA calculations

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

Sr. No.	Name of Instrument	Current Rating FY2019				Chronology of Rating History for the past 3 years		
		Type	Rated amount (Rs. crore)	Amount Outstanding (Rs. Crore)	April 2018	FY2017 Mar-17	FY2016 Feb-16	FY2015 Mar-15
1	Certificate of deposits	Short Term	10,000.00	10,000.00	[ICRA] A1+	[ICRA] A1+	N.A.	N.A.
2	Lower Tier II Bonds – Basel II	Long Term	800.00	800.00	[ICRA] AA+ (stable)	[ICRA] AA+ (stable)	[ICRA] AA+ (stable)	[ICRA] AA+ (stable)
3	Basel II Compliant Innovative Perpetual Debt instruments	Long Term	200.00	200.00	[ICRA] AA (stable)	[ICRA] AA (stable)	[ICRA] AA (stable)	[ICRA] AA (stable)
4	Basel II Compliant Innovative Perpetual Debt instruments	Long Term	200.00	-	[ICRA] AA (stable) withdrawn	[ICRA] AA (stable)	[ICRA] AA (stable)	[ICRA] AA (stable)

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

Annexure-1: Instrument Details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Certificate of Deposits	-	-	7-365 days	10,000.00	[ICRA]A1+
INE692A09167	Lower Tier II bonds	17-Sep-2008	10.95%	16-Sep-2018	400.00	[ICRA]AA+(stable)
INE692A09175	Lower Tier II Bonds	23-Dec-2008	9.50%	22-Dec-2018	200.00	[ICRA]AA+(stable)
INE692A09183	Lower Tier II Bonds	30-Dec-2008	8.60%	29-Dec-2018	200.00	[ICRA]AA+(stable)
INE692A09159	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

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About ICRA Limited:

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Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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