UCO Bank

July 25, 2018

Summary of rated instruments

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Lower Tier II Bonds – Basel II	800.00	800.00	[ICRA]A+ (Negative); Reaffirmed
Upper Tier II Bonds – Basel II	500.00	500.00	[ICRA]A- (Negative); Reaffirmed
Total	**1,300.00**	**1,300.00**	

**Instrument details are provided in Annexure-1*

Rating action

ICRA has reaffirmed the rating of [ICRA]A+ (pronounced ICRA A plus) for the Rs. 800-crore Lower Tier II bond programme and [ICRA]A- (pronounced ICRA A minus) for the Rs. 500-crore Upper Tier II bond programme of UCO Bank (UCO). The outlook on the long-term ratings is Negative.

Rationale

The rating reaffirmation with Negative outlook factors in the bank's weak operational and financial profile reflected by its continued losses. The bank reported the third consecutive year of losses with net loss of Rs. 4,436 crore during FY2018 (Rs. 1,851 crore in FY2017 and Rs. 2,799 crore in FY2016). ICRA expects the losses to continue during FY2019, on account of weak operating profitability, and high credit provisions because of weak asset quality (net NPAs of 13.10% as on March 31, 2018). Further, because of the continued losses and despite large capital infusions by the Government of India (GoI) of Rs. 6,507 crore during FY2018 (Rs. 1,925 crore during FY2017 and Rs. 935 crore during FY2016), the capital ratios are expected to remain weak given the regulatory dispensations[1] of Rs. 942 crore (0.89% of risk-weighted assets - RWAs) availed for FY2018. Further, during Q1 FY2019, the bank exercised the early call option under a regulatory event for Tier I bonds totalling Rs. 750 crore (0.71% of RWAs as on March 31, 2018). Therefore, after adjusting the regulatory dispensation and the recall of the Tier I bonds, the bank's adjusted Tier I ratio was much lower at 7.34% compared to the reported level of 8.94% as on March 31, 2018.

The coupon payment on the bank's Upper Tier II bonds are due in September 2018. If the bank is unable to meet the minimum Tier I requirement of 7.0% and, hence, the capital adequacy ratio (CRAR) of 9.0% before the coupon payment dates because of expected losses in Q1 FY2019, it may not be able to service the coupon payments as per the covenants of the bond. Accordingly, timely capital infusion before the coupon payment dates will be critical. The GoI has supported five public-sector banks (PSBs) in July 2018, with capital infusion of Rs. 11,336 crore, to shore up their capital ratios and enable them to service their debt capital instruments as per the covenants of these instruments. While this reinforces the sovereign support for PSBs, UCO Bank has not received any capital during FY2019 (YTD). With the bank expected to report

[1] *These dispensations pertain to lower provisioning on the National Company Law Tribunal (NCLT) accounts, the amortisation of mark-to-market (MTM) losses on the investment portfolio and deferment of gratuity liability*

losses again in FY2019, the coupon servicing on the Upper Tier II bonds is contingent on timely capital support from the GoI for maintaining regulatory Tier I of 7.0% and CRAR of 9.0%.

ICRA expects the bank to report losses during FY2019 and a capital infusion to offset the losses and improve the capital ratios to meet the regulatory requirements. Assuming a 5-10% decline in the RWAs, ICRA expects that the bank will require a large capital infusion of ~Rs. 5,800-6,200 crore (~81-87% of its market capitalisation) during FY2019 to report a minimum Tier I capital ratio of 9.5% (including CCB of 2.5%). If the bank does not maintain the CCB and meets only the Tier I requirement of 7.0% and, hence, a CRAR of 9.0%, the capital requirement will be lower at ~Rs. 3,000 crore (~42% of its market capitalisation). Timely capital support from the GoI will be critical for the bank to meet the minimum required capital ratios and will be a key rating sensitivity for the rating of the Upper Tier II bonds.

The ratings continue to factor in the majority sovereign ownership by the GoI, its demonstrated support for capital infusion, and the bank's strong franchise, which translates into a healthy and stable deposits base.

Outlook: Negative

ICRA expects the bank's capital requirements to remain significant in FY2019 and may downgrade the ratings if the bank reports CRAR below the regulatory levels[2], maintains the CCB below the regulatory levels and if timely capital infusion does not materialise.

Key rating drivers

Credit strengths

Majority sovereign ownership - The GoI held 90.80% equity in the bank, as on June 30, 2018. The GoI, which has demonstrated consistent capital support to the bank, infused Rs. 1,925 crore and Rs. 6,507 crore of equity capital during FY2017 and FY2018, respectively. A high GoI shareholding provides the bank with the ability to raise capital from market sources while maintaining a majority GoI shareholding. However, given the bank's weak operating and financial profile, its ability to raise capital from the market remains to be seen. In the absence of the same, the bank will remain significantly dependent on the GoI to meet the regulatory capital ratios. ICRA expects that the GoI will provide capital to PSBs, including UCO Bank, to meet the regulatory capital ratios. During FY2019 (YTD), FY2018 and FY2017, the GoI has infused Rs. 11,326 crore, Rs. 90,000 crore and Rs. 25,000 crore into PSBs to support their capital requirements.

Strong franchise resulting in stable deposit base - The bank has a strong franchise with 3,108 branches, including two in Hong Kong and two in Singapore as on March 31, 2018. It is mainly focussed on rural and semi-urban segments, with around 61% of its branches being in these areas. This also supports the bank's low cost current account and savings account (CASA) deposits, which were 35.5% of total deposits as on March 31, 2018 compared to 31.2% as on March 31, 2017. Though the bank's deposit base declined by 9.7% YoY, as on March 31, 2018, with a reduction in the asset base, however its core deposit base continued to improve with CASA balances growing 2.8% during FY2018. A steady and growing core deposit base also imparts comfortable liquidity to the bank. Moreover, the bank's average liquidity coverage ratio was 200.91% during FY2018 against the regulatory requirement of 100% as on January 1, 2019.

Credit challenges

Capital ratios to remain weak with large capital requirement and high GoI dependence during FY2019 - UCO reported Tier I and CRAR of 8.94% and 10.94%, respectively, with the capital ratios remaining just above the minimum regulatory

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[2] *Tier I of 7% or CRAR of 9%, excluding capital conservation buffer(CCB) required of 1.875% as on March 31, 2018 and 2.5% as on March 31, 2019*

Tier I and CRAR (including CCB) levels of 8.875% and 10.875%, respectively, as on March 31, 2018. The capital ratios were weak despite the GoI's capital infusion of Rs. 6,507 crore during FY2018. The bank's capital ratios, with a buffer of just 6 bps on Tier I and CRAR, would have been below the regulatory requirements, as on March 31, 2018, had it not availed forbearances deferring provisioning requirements during FY2018. The deferred provisions include a) the Reserve Bank of India's (RBI) dispensation on lower provisioning by Rs. 460 crore for NCLT accounts of 40% (instead of the minimum 50%), which will be required to be provided for in Q1 FY2019, b) amortisation of MTM losses on the investment portfolio of Rs. 315.8 crore, and c) deferment of gratuity liability of Rs. 166.1 crore post enhancement of gratuity limits. Had the total provisions of Rs. 942 crore not been deferred, losses would have been higher resulting in lower CET I and Tier I ratios by around 0.89% (based on RWAs as on March 31, 2018).

Further, in Q1 FY2019, the bank exercised the early call option for Tier I bonds of Rs. 750 crore (0.71% of RWAs as on March 31, 2018) under a regulatory event as the bank was placed under the RBI's prompt corrective action (PCA) framework. If adjusted for both these events, the Tier I capital ratio would stand lower by 1.6% of RWAs. ICRA notes that with the limited capital cushion and expected losses during FY2019, the bank will need to raise capital immediately. The bank's board has approved the raising of Rs. 3,000 crore of equity capital in FY2019 to support the weak capital ratios.

ICRA expects that the bank will require large capital infusion of ~Rs. 5,800-6,200 crore (~81-87% of its market capitalisation), assuming a 5-10% decline in RWAs, during FY2019 to report a minimum Tier I capital ratio of 9.5% including CCB of 2.5%. If the bank does not maintain the CCB, the capital requirement will be lower at ~Rs. 3,000 crore (~42% of its market capitalisation). Given its large capital requirements, ICRA expects the bank will not be able to maintain the CCB in the near to medium term.

Weak asset quality to remain during FY2019 - The asset quality continues to deteriorate with gross NPAs (GNPAs) of 24.64% at the end of Q4 FY2018 (17.12% at the end of Q4 FY2017 and 20.64% at the end of Q3 FY2018), which remained above the PSB average. The rise in the GNPA ratio was due to an increase in the absolute level of GNPAs to Rs. 30,550 crore as on March 31, 2018 from Rs. 22,541 crore as on March 31, 2017, coupled with a decline in gross advances. The provision coverage ratio stood at 53.90% (61.38% including technical write-offs or TWO) as on March 31, 2018 compared to 52.52% (61.17% including TWO) as on March 31, 2017. As a result of higher GNPAs, the net NPAs (NNPAs) increased to 13.10% as on March 31, 2018 (8.94% as on March 31, 2017). Further, despite large capital infusion in Q4 FY2018, rising net NPAs resulted in a weak solvency profile as reflected by NNPAs/net worth of 112% at the end of Q4 FY2018 (103% at the end of Q4 FY2017), weaker than the PSB average. ICRA expects the bank to report a high slippage rate of ~4.5-5.5% during FY2019 (13.8% in FY2018), which is likely to translate into a GNPA ratio of ~26.5-27.5% as on March 31, 2019.

Weak earnings profile, marked by three consecutive years of losses, with the same expected to continue in FY2019 - The bank's net interest income (NII) declined 18.1% YoY to Rs. 3,125 crore during FY2018 mainly due to interest reversals because of fresh slippages and high non-earning assets. With the decline in the NII being higher than the decline in operating expenses, the core operating profitability (excluding credit provisions and profits from treasury activities) has been weakening and is insufficient to absorb the high credit provisions. The bank reported weak core operating profits of Rs. 1,036 crore during FY2018 compared to Rs. 1,685 crore during FY2017, which resulted in a decline in the core operating profits to average total assets at 0.47% (FY2018) compared to 0.71% (FY2017).

UCO continued to report losses over the last three consecutive fiscal years with loss before tax of Rs. 4,427 crore during FY2018, Rs. 1,840 crore during FY2017 and Rs. 2,779 crore during FY2016. The bank's losses increased due to elevated provisioning of Rs. 5,761 crore during FY2018 compared to Rs. 4,766 crore during FY2017 on account of NPA ageing coupled with the RBI's February 2018 circular wherein the threshold for stress resolution was reduced to special mention account (SMA) status of the borrower, thereby leading to the early recognition of stress. Consequently, the provisions spiked to Rs. 2,239 crore during Q4 FY2018, which resulted in a huge loss before tax of Rs. 2,127 crore compared to loss before tax of Rs. 582 crore and Rs. 1,016 crore during Q4 FY2017 and Q3 FY2018, respectively. ICRA expects a similar trend during FY2019 wherein UCO's credit provisions will be higher than its operating profits, thereby resulting in net losses. However, the extent of recovery from the resolution of accounts under NCLT will be crucial for ascertaining the level of losses and capital required for FY2019.

Risk of being placed in higher threshold under PCA framework - During May 2017, the RBI included UCO in threshold 1 of the PCA framework, given the bank's high NNPAs and negative return on assets. With the bank reporting NNPA of 13.1% as on March 31, 2018, it might be placed in threshold 3 as per the RBI's guidelines. The bank has also received the RWA reduction target from the GoI and the RBI recently restricted certain banking activities related to lending and bulk deposit-taking operations of PCA banks. Any such restriction on UCO will further hamper its recovery and capital-raising ability.

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

UCO Bank was established in 1943 as United Commercial Bank and was nationalised in 1969. The bank was wholly owned by the GoI until September 2003, when an initial public offer resulted in the GoI's stake reducing to 75%. As on June 30, 2018, the GoI held a 90.80% stake in the bank. As on March 31, 2018, the bank operated 3,108 branches, including two branches in Hong Kong and two in Singapore. The bank is focussed on the rural and semi-urban segments, with around 61% of its branches being in these areas. The bank operated 2,769 ATMs as on March 31, 2018.

For FY2018, the bank reported a net loss of Rs. 4,436 crore on an asset[3] base of Rs. 2,13,704 crore compared to a net loss of Rs. 1,851 crore on an asset base of Rs. 2,29,015 crore for FY2017. As on March 31, 2018, the bank's capital adequacy ratio was 10.94% (Tier-1: 8.94%; both Basel III), while its gross and net NPAs stood at 24.64% and 13.10%, respectively.

[3] *Asset figure is excluding revaluation reserves*

Key financial indicators (audited) - Standalone

	FY2017	FY2018	Q4FY2017	Q4FY2018
Net interest income	3,817	3,125	609	808
Profit before tax	(1,840)	(4,427)	(582)	(2,127)
Profit after tax	(1,851)	(4,436)	(588)	(2,134)
Net advances	1,19,724	1,07,470	1,19,724	1,07,470
Total assets (excluding revaluation reserves)	2,29,015	2,13,704	2,29,015	2,13,704
% CET 1	7.64%	8.23%	7.64%	8.23%
% Tier 1	8.27%	8.94%	8.27%	8.94%
% CRAR	10.93%	10.94%	10.93%	10.94%
% Net interest margin / Average total assets	1.62%	1.41%	1.05%	1.52%
% Net profit / Average total assets	-0.78%	-2.00%	-1.01%	-4.01%
% Return on net worth	-17.75%	-35.19%	-22.86%	-72.46%
% Gross NPAs	17.12%	24.64%	17.12%	24.64%
% Net NPAs	8.94%	13.10%	8.94%	13.10%
% Provision coverage excl. technical write offs	52.52%	53.90%	52.52%	53.90%
% Net NPA/ Net worth	102.64%	111.71%	102.64%	111.71%

Amounts in Rs. crore; Net worth excludes revaluation reserves

Source: UCO Bank; ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

Sl. No	Instrument	Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. Crore)	Current Rating (FY2019) Date & Rating in FY2019	Chronology of Rating History for the past 3 years: Date & Rating in FY2019	Date & Rating in FY2018		Date & Rating in FY2017			Date & Rating in FY2016
					July 2018	May 2018	Aug 2017	June 2017	June 2016	May 2016	April 2016	Feb 2016
1	Lower Tier II Bonds	Long Term	800.00	800.00	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]AA- (Negative)	[ICRA]AA- (Negative)	[ICRA]AA (Negative)	[ICRA]AA (Negative)
2	Upper Tier II Bonds	Long Term	500.00	500.00	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A (Negative)	[ICRA]A+ (Negative)	[ICRA]AA- (Negative)	[ICRA]AA- (Negative)

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 / Allotment	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE691A09169	Lower Tier II Bonds	08-Mar-2010	8.92%	08-Mar-2020	800.00	[ICRA]A+(Negative)
INE691A09177	Upper Tier II Bond	25-Mar-2010	8.90%	25-Mar-2025 (Call:25-Mar-2020)	500.00	[ICRA]A-(Negative)

Source: UCO Bank, ICRA research

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