UCO Bank

November 21, 2018

Summary of rated instrument

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); Outstanding
Upper Tier II Bonds – Basel II	500.00	500.00	[ICRA]A- &, placed on rating watch with developing implications
Total	**1,300.00**	**1,300.00**	

& - Under Rating Watch with Developing Implications

Material event

UCO Bank (UCO) announced its quarterly results on November 12, 2018. As expected, the bank continued to report net losses with a loss after tax of Rs. 1,136 crore during Q2 FY2019 compared to a loss after tax of Rs. 623 crore in Q2 FY2018 and Rs. 634 crore in Q1 FY2019. With continuing losses and no fresh equity capital infusion during H1 FY2019, the bank's capital ratios declined below the minimum regulatory requirement of Tier I[1] and CRAR of 7.0% and 9.0%, respectively. UCO reported weak capital ratios with Tier I and CRAR of 5.57% and 7.57%, respectively, as on September 30, 2018.

Rating action

ICRA has placed the rating of [ICRA]A- (pronounced ICRA A minus) for the Rs. 500-crore Upper Tier II Bonds programme of UCO on Rating Watch with Developing Implications (RWD). ICRA also has an outstanding rating of [ICRA]A+ (pronounced ICRA A plus) on the Rs. 800-crore Lower Tier II bonds programme of UCO[2]. ICRA believes that the rating on the Lower Tier II bonds programme is likely to remain unchanged and has not placed it on RWD. The outlook on the long-term rating of the Lower Tier II bonds programme is Negative.

Rationale

The rating on the Upper Tier II bonds programme was placed on RWD due to the deterioration in the capital adequacy ratios, which were below the regulatory levels as on September 30, 2018. Maintaining the capital ratios above the regulatory levels is critical for servicing the coupon on the bank's Basel II debt capital instruments[3]. In July 2018 (click here for the previous rationale), ICRA had pointed out UCO's weak capital ratios and its high dependence on the Government of India (GoI) for its large capital requirements in FY2019 to meet the regulatory capital ratios. The GoI has regularly demonstrated capital support for many public sector banks (PSBs) over the last few years. During FY2019 (YTD), the GoI infused capital in several PSBs to shore up their capital ratios and enable them to service their debt capital instruments as per the covenants of these instruments. Though this demonstrates sovereign support for PSBs, UCO has not received any capital during FY2019 (YTD). Hence, the timely capital infusion, before the coupon payment dates, to shore up its capital ratios above the regulatory levels will be critical for servicing the coupon payment on the Upper Tier II bonds. The coupon payment on the bank's Upper Tier II bonds are due in March 2019.

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[1] *Excluding capital conservation buffer (CCB) required of 1.875% as on March 31, 2018 and 2.5% as on March 31, 2019*

[2] *For complete rating scale and definitions, please refer to ICRA's website www.icra.in or other ICRA Rating Publications*

[3] *Innovative perpetual debt instruments (IPDIs) and Upper Tier II bonds – in a year of loss, the capital instruments can be serviced with prior approval from the RBI subject to the bank meeting minimum regulatory capital ratios (Tier I of 7.0% and CRAR of 9.0%)*

ICRA expects the losses to continue for the bank during FY2019 as the likely elevated credit provisions are expected to surpass its weak operating profitability. The high credit provisions are due to its weak asset quality with net NPAs of 11.97% as on September 30, 2018. Assuming a 5-10% decline in the risk-weighted assets (RWAs), ICRA expects that the bank will require a large capital infusion of ~Rs. 5,800-6,200 crore (~77-82% of its market capitalisation) during FY2019 to report a minimum Tier I capital ratio of 9.5% (including CCB of 2.5%). Given the large quantum of capital requirement to meet the CCB, ICRA does not expect the bank to maintain the CCB in the medium term and expects it to meet only the minimum Tier I requirement of 7.0% and, hence, a CRAR of 9.0%. Accordingly, in this scenario, the capital requirement will be lower at ~Rs. 3,000 crore (~40% of its market capitalisation). ICRA will closely monitor the quantum and timing of capital infusion by the GoI. Further, ICRA will resolve the rating watch based on the quantum of capital raised by the bank.

The ratings continue to factor in the GoI's majority sovereign ownership in the bank at 90.80% as on September 30, 2018 and its demonstrated support for capital infusion, as well as the bank's strong deposit franchise, which translates into a healthy and stable deposit 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[4], and if timely capital infusion does not materialise as this will impact its ability to service its debt capital instruments.

Key rating drivers

Credit strengths

Majority sovereign ownership - The GoI held 90.80% equity in the bank, as on September 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 its weak operating and financial profile, the bank's 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 and this will be critical from a near-term rating perspective.

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 June 30, 2018 compared to 30.9% as on June 30, 2017. Though the bank's deposit base declined by 8.8% YoY, as on June 30, 2018, with a reduction in the asset base, however its core deposit base continued to improve with CASA balances rising 4.6% YoY during Q1 FY2019. 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.

[4] *Tier I of 7% or CRAR of 9%, excluding CCB required of 1.875% as on March 31, 2018 and 2.5% as on March 31, 2019*

Credit challenges

Capital ratios below regulatory levels, timely capital infusion critical for servicing debt capital instruments - As expected, the bank's capital ratios were below the minimum regulatory requirement (excluding CCB) of Tier I of 7% and CRAR of 9%. The bank reported weak capital ratios with CET I, Tier I and CRAR of 5.57%, 5.57% and 7.57%, respectively, as on September 30, 2018 compared to 7.02%, 7.02% and 9.18%, respectively, as on June 30, 2018. The decline in the capital ratios was mainly on account of a huge loss before tax of Rs. 1,136 crore during Q2 FY2019.

ICRA notes that with losses expected during FY2019, the bank will need to raise capital immediately to maintain the capital ratios above the regulatory requirement. 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 a large capital infusion of ~Rs. 5,800-6,200 crore (~77-82% 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%. Given the large quantum of capital requirement to meet the CCB, ICRA does not expect the bank to maintain the CCB in the medium term and expects it to meet only the minimum Tier I requirement of 7.0% and, hence, a CRAR of 9.0%. Accordingly, in this scenario, the capital requirement will be lower at ~Rs. 3,000 crore (~40% of its market capitalisation). Timely capital support from the GoI will be a key rating sensitivity for the Upper Tier II bonds.

Asset quality pain to remain during FY2019 - UCO continues to report weak asset quality with gross NPAs (GNPAs) of 25.37% at the end of Q2 FY2019 (19.74% at the end of Q2 FY2018 and 25.71% at the end of Q1 FY2019), which remained above the PSB average. The absolute level of GNPAs remained elevated at Rs. 29,581 crore as on September 30, 2018 (Rs. 29,786 crore as on June 30, 2018). However, the provision coverage ratio improved to 60.04% (67.61% including technical write-offs or TWO) as on September 30, 2018 compared to 57.84% (65.15% including TWO) as on June 30, 2018. As a result, the absolute level of net NPAs (NNPAs) declined to Rs. 11,820 crore as on September 30, 2018 from Rs. 12,558 crore as on June 30, 2018. Consequently, the NNPAs ratio declined marginally to 11.97% as on September 30, 2018 from 12.74% as on June 30, 2018. Further, an elevated NNPA level resulted in a weak solvency profile as reflected by NNPA/net worth of 109% at the end of Q2 FY2019 (105% at the end of Q1 FY2019), weaker than the PSB average. ICRA expects the bank to report a high slippage rate of ~4.5-5.5% during FY2019 (8.3% in Q1 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 - UCO's net interest income (NII) increased by 47.2% YoY to Rs. 965 crore in Q2 FY2019 mainly driven by a 9.9% decline in interest expenses. However, the NII declined by 21.5% on a QoQ basis mainly due to a 6.8% QoQ decline in interest income due to the resolution of a few accounts in Q1 FY2019. The yield on advances increased to 7.8% on a YoY basis during Q2 FY2019 (7.1% in Q2 FY2018 and 8.1% in Q1 FY2019), whereas the cost of average interest-bearing funds declined to 5.3% during Q2 FY2019 (5.6% in Q2 FY2018 and 5.3% in Q1 FY2019). The yield on advances improved mainly due to lower interest reversal. As a result, the net interest margins (NIMs; as a percentage of average total assets – ATA) increased to 1.9% on a YoY basis during Q2 FY2019 (1.2% in Q2 FY2018 and 2.3% in Q1 FY2019).

Further, the bank's core operating profit (excluding credit provisions and profits from treasury activities) deteriorated to -0.02% of ATA (Q2 FY2019) from 1.3% of ATA (Q1 FY2019) and -0.46% (Q2 FY2018). The operating profit was insufficient to absorb the high credit provisions (5.7% of advances in Q2 FY2019 compared to 4.7% in Q2 FY2018 and 7.9% in Q1 FY2019) resulting in a loss before tax of Rs. 1,136 crore during Q2 FY2019 compared to a loss before tax of Rs. 621 crore and Rs. 625 crore during Q2 FY2018 and Q1 FY2019, respectively. UCO continued to report losses over the last three consecutive fiscal years with a loss before tax of Rs. 4,427 crore during FY2018, Rs. 1,840 crore during FY2017 and Rs. 2,779 crore during FY2016 primarily due to elevated provisioning on account of the weak asset quality. 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 the National Company Law Tribunal NCLT will be crucial for ascertaining the level of losses and capital required for FY2019. Due to the bank's high NNPAs and negative return on assets, the RBI included UCO in threshold 1 of the prompt corrective action (PCA) framework in May 2017. The bank also received an RWA reduction target from the GoI, which will certainly constrain its ability to expand. Consequently, the bank needs to take corrective actions such as capital infusion and improvement in the asset quality and profitability levels.

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 September 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. It operated 2,769 ATMs as on March 31, 2018.

In FY2018, the bank reported a net loss of Rs. 4,436 crore on an asset[5] 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. During H1 FY2019, the bank posted a net loss of Rs. 1,770 crore compared to a net loss of Rs. 1,286 crore in H1 FY2018. As on September 30, 2018, the bank's capital adequacy ratio was 7.57% (Tier I: 5.57%; both Basel III), while its gross and net NPAs stood at 25.37% and 11.97%, respectively.

Key financial indicators - Standalone

	FY2018	Q2 FY2018	Q2 FY2019	H1 FY2018	H1 FY2019
Net interest income	3,125	655	965	1,497	2,193
Profit before tax	(4,427)	(621)	(1,136)	(1,284)	(1,761)
Profit after tax	(4,436)	(623)	(1,136)	(1,286)	(1,770)
Net advances	1,07,470	1,10,294	98,820	1,10,294	98,820
Total assets (excluding revaluation reserves)	2,13,704	2,14,069	2,08,552	2,14,069	2,08,552
% CET 1	8.23%	6.64%	5.57%	6.64%	5.57%
% Tier 1	8.94%	7.32%	5.57%	7.32%	5.57%
% CRAR	10.94%	9.32%	7.57%	9.32%	7.57%
% Net interest margin / Average total assets	1.41%	1.20%	1.87%	1.35%	2.08%
% Net profit / Average total assets	-2.00%	-1.14%	-2.20%	-1.16%	-1.68%
% Return on net worth	-35.19%	-25.74%	-39.86%	-25.69%	-30.21%
% Gross NPAs	24.64%	19.74%	25.37%	19.74%	25.37%
% Net NPAs	13.10%	9.98%	11.97%	9.98%	11.97%
% Provision coverage excl. technical write-offs	53.90%	54.95%	60.04%	54.95%	60.04%
% Net NPA/ Net worth	111.71%	114.84%	109.09%	114.84%	109.09%

Amounts in Rs. crore; Net worth excludes revaluation reserves
Source: UCO Bank, ICRA research

[5] *Asset figure excludes revaluation reserves*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

		Current Rating (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
Sl. No	**Instrument**	**Type**	**Amount Rated (Rs. crore)**	**Amount Outstanding (Rs. crore)**	**Nov 2018**	**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]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-&	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A (Negative)	[ICRA]A+ (Negative)	[ICRA]AA- (Negative)	[ICRA]AA- (Negative)

& Under Rating Watch with Developing Implications

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- &

Source: UCO Bank, ICRA research

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