December 20, 2019

Indian Overseas Bank: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)[1]	Rating Action
Basel III Compliant Tier-II Bonds	300.00	300.00	[ICRA]A+ (hyb) (Negative); reaffirmed
Basel II - Lower Tier-II Bonds	1,000.00	1,000.00	[ICRA]A+ (Negative); reaffirmed
	290.00	0.00	[ICRA]A+ (Negative); withdrawn
Basel II - Upper Tier-II Bonds	967.00	967.00	[ICRA]A- (Negative); reaffirmed
	510.00	0.00	[ICRA]A- (Negative); withdrawn
Basel II - Perpetual Bonds	300.00	0.00	[ICRA]A- (Negative); withdrawn
Basel III Compliant Tier-II Bonds	800.00	800.00	[ICRA]A+ (hyb) (Negative); reaffirmed
Certificates of Deposit	15,000.00	15,000.00	[ICRA]A1+; reaffirmed
Total	**19,167.00**	**18,067.00**	-

** Instrument details are provided in Annexure-1*

The letters, hyb, in parenthesis, suffixed to a rating symbol stand for hybrid and indicate that the rated instrument is a hybrid subordinated instrument with equity-like loss-absorption features. Such features may translate into higher levels of rating transition and loss severity vis-à-vis conventional debt instruments. The rated Tier-II bonds are expected to absorb losses once the point of non-viability (PONV) trigger is invoked.

The one notch lower rating assigned to the Basel II Upper Tier-II Bonds and Basel II Compliant Perpetual Bond Programme compared with the rating for the bank's Tier-II Bonds 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 regulatory norms for hybrid debt capital instruments need regulatory approval from the Reserve Bank of India (RBI) for debt servicing (including principal repayments) in case the bank reports a loss and is not liable to service the debt if it breaches the minimum regulatory capitalisation norms, i.e. CRAR of 9.0% without a capital conservation buffer (CCB).

Rationale

The ratings reaffirmation considers the majority ownership of the Government of India (GoI; 92.5% stake as on September 30, 2019) and the demonstrated sovereign support through capital infusions over the past few years. The bank's deposit base remains stable, supported by its good established retail franchise that also supports its liquidity profile.

The Negative outlook continues to reflect IOB's weak asset quality indicators and solvency[2] indicators, which are expected to exert pressure on its earnings. The ratings factor in the bank's weak asset quality indicators with high gross fresh slippages and subdued recoveries, thereby translating into gross non-performing advances (gross NPA) of 20.04% and net NPA of 9.85% as on September 30, 2019. Consequently, the credit provisioning requirement has remained elevated, thereby resulting in net losses since FY2015 with the same expected to continue in FY2020. The ratings further take note of the below-average capitalisation position maintained by IOB in the recent past though the CET-I has

[1] Rs. 1 crore = Rs. 10 million = Rs. 100 lakh

[2] Net NPA / CET

improved to 9.20% after factoring in the capital infusion (Rs. 3,857 crore) by the GoI in September 2019. As the earnings profile is expected to remain weak in the near term, the bank continues to shrink its advances and risk-weighted assets (RWAs) to conserve capital. Due to the high level of net NPAs, IOB has been operating under the RBI's prompt corrective action (PCA) framework since October 2015, which constrains its lending operations apart from imposing other restrictions. ICRA expects the bank to require additional capital if it intends to exit the PCA framework by March 2020.

Key rating drivers and their description

Credit strengths

Sovereign ownership with demonstrated capital support from GoI – The GoI held 92.5% equity in the bank as on September 30, 2019. The GoI infused cumulative capital of ~Rs. 10,657 crore in FY2018 and FY2019, which supported the bank's capital profile even though it reported huge losses. Further, the GoI infused Rs. 3,857 crore of equity in September 2019 under the its recapitalisation programme to support the bank, which is currently placed under the RBI's restrictive PCA framework. However, in ICRA's view, the bank will require additional capital if it has to reduce its net NPAs to <6% while maintaining the capital ratios above the regulatory levels including a CCB of 2.5% of RWAs required as on March 31, 2020. ICRA expects the GoI to provide sufficient capital support to the bank to meet the regulatory capital ratios (excluding CCB) on an ongoing basis, if required.

Improving deposit profile supported by established franchise with widespread branch network in South India – IOB has a long-standing presence and established retail franchise in South India with a total branch network of 3,276 as on September 30, 2019 (3,303 as on September 30, 2018). The bank's deposits have remained stable at Rs. 2.2-2.3 lakh crore since June 2015. However, the share of CASA deposits improved to 38.1% as on September 30, 2019 from 35.9% as on September 30, 2018 (25.4% as on June 30, 2015). The improvement in the share of CASA deposits was, however, driven by the limited credit growth pursued by the bank because of its weak capital position. With limited credit growth and natural growth of the core deposit base, the need for chasing bulk deposits reduced and the share of CASA deposits improved over the years. The reliance on bulk deposits remained high at ~11.6% of total deposits as on September 30, 2019, though it declined from ~14.5% of total deposits as on September 30, 2018. Supported by the improving share of CASA deposits, the cost of interest-bearing funds for the bank has been improving over the last few years compared to the banking sector average, even though this remains slightly above the average for public sector banks (PSBs).

Credit challenges

Gross fresh slippages remain high in FY2019 and likely to remain so in FY2020 – The gross fresh slippages in H1 FY2020 amounted to ~Rs. 3,904 crore, translating into an annualised slippage rate of 6.6% of standard assets (7.9% in FY2019 and 13.9% in FY2018). The slippages remained high across the sector with gross NPA of 41% in the industrial sector, 11% in the agriculture sector, 19% in the services sector and 2.5% in retail advances as on March 31, 2019 (46.8%, 11.7%, 25.6% and 1.7%, respectively, as on March 31, 2018). The slippages for PSBs, on an average, were lower in H1 FY2020 at 4.1% of standard assets (4.7% in FY2019 and 8.3% in FY2018). Despite the high slippages, the overdue advances remained high with SMA 1 and SMA 2 advances of Rs. 5,560 crore (4.3% of standard advances) as on June 30, 2019. Of these, the top 10 SMA-2 accounts formed 1.7% of the advances as on June 30, 2019. Hence, the slippages are expected to remain high in FY2020. Overall, ICRA expects the slippages to remain high at 5.5-6.0% in FY2020.

Weak asset quality indicators and solvency profile despite expected improvement – IOB's asset quality remains weak as the gross NPAs were high at 20.04% as on September 30, 2019 (22% as on March 31, 2019 and 25.4% as on March 31,

2018) because of continued slippages and subdued recoveries. The gross NPA reduced in absolute terms to Rs. 28,674 crore as on September 30, 2019 from Rs. 33,398 crore as on March 31, 2019 and Rs. 38,180 crore as on March 31, 2018. This was mainly supported by write-offs (including sale to ARCs) of Rs. 6,873 crore in H1 FY2020 (Rs. 8,391 crore in FY2019 and Rs. 10,272 crore in FY2018). Including the write-offs, the gross NPAs are estimated at 24% as on September 30, 2019 compared to 28.4% as on March 31, 2018.

IOB's provision coverage ratio, including write-offs, was much lower at ~64% as on September 30, 2019 (~60% as on March 31, 2019 and ~52% as on March 31, 2018) compared to that for the PSBs at 77.3% as on September 30, 2019, 75.2% as on March 31, 2019 and 62.1% as on March 31, 2018. Due to the relatively high gross NPA levels and lower provision cover, IOB's net NPAs also remained elevated at 9.85% compared to the PSB average of 4.80% as on September 30, 2019. The weaker capital position and higher net NPA levels translated into a weak solvency profile with Net NPAs / Core Equity of 113% as on September 30, 2019, weakest among all PSBs, though this improved from 150% as on March 31, 2019 because of the capital infusion by the GoI in H1 FY2020.

The bank has exposure to 30 large accounts, referred under the Insolvency and Bankruptcy Code (IBC), constituting 8.6% of advances as on March 31, 2019, against which it had provisions of about 83% as on March 31, 2019. Given the significant quantum of provisions held by the bank for the cases being resolved under the IBC, effective recoveries from these accounts can result in writebacks and remain a key driver for reduction in NPA levels as well as improvement in the asset quality.

Losses to continue in FY2020 as well; IOB to remain under PCA unless supported by additional capital – IOB has reported losses since FY2015 largely because of its weak asset quality and elevated credit provisions. Despite the elevated gross NPAs, the bank has been able to maintain its NIMs (as a percentage of average total assets - ATA) at 2.0-2.2%, supported by the reducing cost of interest-bearing funds. The NIMs were marginally lower than the PSBs' average of 2.2-2.4%. The share of non-interest income for IOB remained higher than the PSB average (1.35% of ATA for IOB compared to ~0.87% for PSBs in FY2019), supported by recoveries from written-off accounts. The operating costs remain comparable for IOB in relation to the PSB average and stood at 1.80% of ATA in FY2019 compared to 1.76% for PSBs. Accordingly, the bank's operating profitability was better in FY2019 at 1.68% of ATA compared to 1.44% for PSBs. The operating profitability (before provisions and net trading income) stood at ~1% of ATA in H1 FY2020 because of the declining yield on assets, compressed NIMs, and higher operating cost of 1.86% for IOB compared to 1.76% for PSBs.

The credit provisions have consistently surpassed IOB's core operating profitability, thereby translating into net losses. The credit provisions stood at 3.3% of ATA in H1 FY2020 against 4% in FY2019 and 4.9% in FY2018, thereby translating into net losses of 2.1% in H1 FY2020 compared to 1.5% in FY2019 and 2.6% in FY2018.

Based on ICRA's estimation of the slippage rate, if the bank has to reduce its net NPAs below 6% by March 31, 2020, the credit provision is estimated at 2.8-3% of ATA for FY2020 (3.3% in H1 FY2020), which is expected to translate into a net loss with RoA of -0.8-1% in FY2020. If the bank does not receive the requisite capital from the GoI, the credit provisions will be lower than the above-mentioned estimates and the net NPAs will remain above 6.0%.

Additional capital requirements to exit PCA framework and for growth – With the recent capital infusion of Rs. 3,857 crore in September 2019, the bank's capital position improved with the CET I as well as the Tier I increasing to 9.2% as on September 30, 2019 from 7.8% as on March 31, 2019. Given the credit provisioning estimates (mentioned earlier) required to bring down the net NPAs to less than 6%, the bank may face challenges to meet the regulatory Tier I requirement of 9.5% (including CCB of 2.5%). In such a scenario, ICRA expects that IOB may continue to curtail growth to meet the regulatory capital requirements. As per ICRA's estimates, with 6-8% degrowth in the RWAs, the bank will require additional capital of ~Rs. 1,200-1,300 crore (9-10% of current market capitalisation) to exit the PCA framework. If the bank witnesses higher recoveries from NPAs or a higher-than-expected reduction in the RWAs, the capital requirement estimates will be lower.

Liquidity position: Strong

IOB has a healthy liquidity profile with a liquidity coverage ratio of 465% as on June 30, 2019 against the regulatory requirement of 100% from January 1, 2019. Moreover, the bank maintained an excess SLR of Rs. 12,996 crore on an average in FY2019, which is equivalent to ~5.8% of the average net demand and time liabilities (NDTL). As per the structural liquidity statement as on June 30, 2019, the bank had positive cumulative mismatches across all buckets up to 1 year. ICRA expects IOB to maintain adequate liquidity on the basis of its decreasing deposit concentration and the short tenure nature of the advances. Further, it can avail liquidity support from the RBI (through reverse repo against excess SLR investments and the marginal standing facility scheme) in case of urgent liquidity needs.

Rating sensitivities

Positive triggers – ICRA could revise the outlook to Stable and/or upgrade the ratings if the bank's solvency level improves with Net NPA/Core Equity of less than 70%, while the net NPAs are maintained below 6% and the capital ratios are above the regulatory level (including CCBs) on a sustained basis.

Negative triggers – ICRA could downgrade the ratings in case of insufficient capital support from the GoI, leading to sustained capital breaches with a CRAR of less than 9.0%, which is critical for servicing the rated debt capital instruments.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Credit Rating Methodology for Banks Impact of Parent or Group Support on an Issuer's Credit Rating
Parent/Group Support	The ratings factor in IOB's sovereign ownership and demonstrated track record of capital infusion by the GoI. ICRA expects the GoI to support IOB with capital infusion, if required.
Consolidation/Standalone	To arrive at the ratings, ICRA has considered the standalone financials of IOB.

About the company

Indian Overseas Bank is a large commercial bank with the Government of India having majority ownership (92.5% as on September 30, 2019). As on September 30, 2019, the bank had an asset base (net of revaluation reserve) of about Rs. 2.5 lakh crore and a network of 3,276 branches. Headquartered in Chennai, IOB has a strong presence in South India. It also has an overseas presence through four foreign branches, one representative office, and one remittance centre.

IOB reported a net loss of Rs. 3,738 crore in FY2019 (net loss of Rs. 6,299 crore in FY2018) on a total asset base of Rs. 2,47,523 crore as on March 31, 2019 (Rs. 2,45,865 crore as on March 31, 2018) translating into an RoA of -1.5% and -2.6%, respectively. For H1 FY2020, the bank reported a net loss of Rs. 2,596 crore (loss of Rs. 1,406 crore in H1 FY2019) on a total asset base of Rs. 2,51,179 crore as on September 30, 2019 (Rs. 2,45,615 crore as on September 30, 2018) translating into an RoA of -2.1% and -1.1%, respectively.

Key financial indicators

For the period ending / At the end of	FY2018	FY2019	H1 FY2019*	H1 FY2020*
No. of months in the period	12	12	6	6
Net interest income	5,468	5,279	2,416	2,492
Profit before tax	-8,632	-5,961	-1,980	-2,580

For the period ending / At the end of	FY2018	FY2019	H1 FY2019*	H1 FY2020*
Profit after tax	-6,299	-3,738	-1,406	-2,596
Net advances (Rs. lakh crore)	1.32	1.33	1.31	1.27
Total assets (Rs. lakh crore; excl. reval reserves)	2.46	2.50	2.46	2.51
%CET I	6.4%	7.8%	7.1%	9.2%
%Tier I	7.2%	7.8%	7.1%	9.2%
%CRAR	9.3%	10.2%	9.1%	11.9%
%Net interest margin	2.2%	2.1%	2.0%	2.0%
%Net profit / ATA	-2.6%	-1.5%	-1.1%	-2.1%
%Return on average net worth	-55.4%	-29.8%	-24.4%	-34.5%
% Gross NPAs	25.4%	22.0%	24.8%	20.04%
% Net NPAs	15.4%	10.8%	14.4%	9.85%
% Provision coverage excl. technical write-offs	46.6%	57.0%	49.1%	56.4%
% Net NPA/ Core equity	211%	150%	208%	113%

Note: Average total asset (ATA) is computed on a year-end/quarter-end basis
**Annualised values*
Amounts in Rs. crore; Source: IOB and ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

S. No	Instrument	Type	Current Rating (FY2020) Rated Amount (Rs. crore)	Amount Outstanding (Rs. crore)	20-December 2019	Chronology of Rating History for the Past 3 Years October 24, 2018	November 24, 2017	November 03, 2016	June 22, 2016	February 22, 2016
1	Basel III compliant Tier-II bonds	Long term	300.00	300.00	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	-	-	-	-
2	Lower Tier-II bonds	Long term	1,000.00	1,000.00	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
3	Upper Tier-II bonds	Long term	967.00	967.00	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A (Negative)
4	Perpetual bonds	Long term	300.00	-	[ICRA]A- (Negative); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A (Negative)
5	Basel III compliant Tier-II bonds	Long term	800.00	800.00	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	-	-
6	Certificates of deposit	Short term	15,000.00	15,000.00	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
7	Lower Tier-II bonds	Long term	290.00	-	[ICRA]A+ (Negative); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
8	Upper Tier-II bonds	Long term	510.00	-	[ICRA]A- (Negative); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A (Negative)
9	Lower Tier-II bonds	Long term	300.00	-	-	[ICRA]A+ (Negative); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
10	Upper Tier-II bonds	Long term	655.30	-	-	[ICRA]A- (Negative);	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A (Negative)

withdrawn

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	Instrument	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Rated Amount (Rs. crore)	Current Rating and Outlook
INE565A09256	Basel III Compliant Tier-II bond	3-Nov-16	9.24%	3-Nov-26	800.00	[ICRA]A+ (hyb) (Negative)
INE565A09264		10-Dec-18	11.70%	10-Dec-28	300.00	[ICRA]A+ (hyb) (Negative)
INE565A09181*	Lower Tier-II bonds	24-Aug-09	8.48%	24-Aug-19	290.00	[ICRA]A+ (Negative); withdrawn
INE565A09215		31-Dec-10	8.95%	31-Dec-20	1,000.00	[ICRA]A+ (Negative)
INE565A09199$	Upper Tier-II bonds	1-Sep-09	8.80%	1-Sep-24	510.00	[ICRA]A- (Negative); withdrawn
INE565A09223@		10-Jan-11	9.00%	10-Jan-26	967.00	[ICRA]A- (Negative)
INE565A09207^	Perpetual bonds	29-Sep-09	9.30%	29-Sep-19	300.00	[ICRA]A- (Negative); withdrawn
NA	Certificates of deposit	-	-	7-365 days	15,000.00	[ICRA]A1+

Source: IOB

** Redeemed by the bank on August 23, 2019*

$ Call option exercised (with prior approval from the RBI) on September 03, 2019

@ Call option can be exercised by the bank at the end of 10 years after approval from RBI

^ Call option available at the end of 10 years (with prior approval from the RBI) has been exercised

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