

December 29, 2020

Indian Overseas Bank: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Tier-II Bonds	1,100.00	1,100.00	[ICRA]A+(hyb)(Negative); reaffirmed
Basel II Lower Tier-II Bonds	1,000.00	1,000.00	[ICRA]A+(Negative); reaffirmed
Basel II Upper Tier-II Bonds	967.00	967.00	[ICRA]A-(Negative); reaffirmed
Total	3,067.00	3,067.00	

*Instrument details are provided in Annexure-1

Rationale

The ratings reaffirmation on the various instruments continues to consider Indian Overseas Bank's (IOB) sovereign ownership and the demonstrated track record of capital support received by the bank. The Government of India (GoI) infused equity capital of ~Rs. 19,974 crore into the bank during FY2018-2020. Along with this, the bank's deposit base remains stable with the improving share of core deposits supported by a well-established deposit franchise, which, in turn, drives its strong liquidity profile.

The bank continues to degrow its advances as it is operating under the prompt corrective action (PCA) framework of the Reserve Bank of India (RBI), given its weak asset quality and capital position. Supported by large capital infusions during the last few years, IOB has been able to provide against its stressed assets and significantly reduce its net non-performing advances (NNPAs) below the PCA threshold. However, aggressive provisions on stressed assets resulted in huge losses as well as limited improvement in the capital position despite the sizeable capital infusions from the GoI. The reduction in the NNPAs also resulted in an improvement in IOB's solvency¹ profile, though it remains weak.

The Covid-19 pandemic-induced economic slowdown has created uncertainty regarding the bank's asset quality with a high share of its loan book remaining under moratorium. Fresh slippages are expected to remain high in FY2021, which could drive weak internal capital generation and continued weakness in the asset quality and capital position. Though ICRA expects the bank's NNPAs to remain below the PCA threshold of 6%, its near-term capital requirements remain sizeable at Rs. 1,400-2,700 crore to achieve the regulatory Tier I ratio (including CCB²). The bank has approved an equity capital raise of up to Rs. 5,000 crore. However, the ability to raise capital remains monitorable, given IOB's weak performance and the limited capital budgeted by the GoI for the recapitalisation of public sector banks (PSBs) in FY2021.

The Negative outlook continues to reflect IOB's weak asset quality and solvency profile, which are expected to be a drag on its earnings and lead to sizeable capital requirements in the near term.

¹ Net non-performing advances / Core capital

² CCB – Capital conservation buffer

Key rating drivers and their description

Credit strengths

Sovereign ownership with demonstrated capital support from Gol – The Gol remains IOB’s largest shareholder, accounting for a 95.84% equity stake as on September 30, 2020. Also, the Gol infused a cumulative ~Rs. 19,974 crore into the bank during FY2018-2020, which supported IOB’s capital profile despite its huge losses. Going forward, ICRA expects the bank to require an additional ~Rs. 1,400-2,700 crore to maintain the capital ratios above the regulatory requirement as on March 31, 2021 (including the CCB of 2.5% required as on April 1, 2021³) while keeping the NNPA ratio below the PCA threshold of 6%. Given its sizeable capital requirements and the limited capital of Rs. 20,000 crore budgeted by the Gol for the recapitalisation of PSBs in FY2021, ICRA expects IOB could remain under the PCA unless it is able to raise capital from the markets. However, ICRA expects the Gol to provide sufficient capital support to the bank to meet the regulatory capital ratios of 9% (CRAR; excluding CCB), which is critical for the servicing of the rated Basel II Upper Tier-II bonds.

Well-developed deposit franchise and strong liquidity position – IOB has a long-standing presence and established retail franchise in South India with a total branch network of 3,221 as on September 30, 2020. While the branch network has been declining over the last few years as the bank has been closing down loss-making branches, its deposit base has remained stable at Rs. 2.1-2.3 lakh crore over the last 4-5 years. Further, with steady growth in the low-cost current account and savings account (CASA) deposit base and the overall stability in the deposit base, the share of CASA deposits improved to 40.3% as on September 30, 2020 from 38.1% as on September 30, 2019 (26.1% as on September 30, 2015). However, the improvement in the share of CASA deposits was driven by the limited credit growth pursued by the bank because of its weak capital position. With limited credit growth and natural growth in the core deposit base, the need for chasing bulk deposits reduced, with bulk deposits accounting for 4.6% of the total deposits as on September 30, 2020 compared to 11.6% as on September 30, 2019. Improving the share of core deposits continues to drive IOB’s strong liquidity profile, though the same is also supported by the low credit-to-deposit ratio because of its weak capital position. 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 PSBs.

Credit challenges

Asset quality to remain weak; slippages to remain high in FY2021 – IOB’s asset quality remains weak with gross fresh slippages of Rs. 7,225 crore (slippage rate of 4.7% of standard advances in FY2020 compared to 4.9% in FY2019). Despite the large slippages, the reduction in GNPA to 14.8% as on March 31, 2020 (from 22.0% as on March 31, 2019) was driven by huge write-offs of ~Rs. 16,800 crore (or 50.30% of opening GNPA as on March 31, 2019) in FY2020. Supported by aggressive provisioning, the bank’s NNPA reduced to Rs. 6,603 crore (5.4%) as on March 31, 2020 from Rs. 14,368 crore (10.8%) as on March 31, 2019.

While the fresh slippages were limited at ~Rs. 231 crore (0.2% of standard advances for H1 FY2021), this was supported by the sizeable loan book under moratorium (~39% in value terms as on August 30, 2020) and the standstill on asset classification. The uncertainty regarding the asset quality remains high, given the economic slowdown on account of the Covid-19-induced stress and the sizeable loan book under moratorium. IOB has a sizeable portion of special mention accounts (SMAs) in SMA-1⁴ and SMA-2 categories, accounting for ~4.6% of the standard advances as on March 31, 2020.

³ RBI has pushed back the deadline to maintain an additional 0.625% CCB to April 1, 2021 from September 30, 2020

⁴ SMA 1 and SMA 2 loans are overdue loans with overdue status of 31-60 days and 61-90 days, respectively

Though the RBI announced a one-time restructuring of loans for borrowers impacted by Covid-19 in August 2020, this facility is not available for SMA1/SMA2 borrowers. Hence, ICRA expects that fresh slippages could remain high at ~4-5% of the standard advances even in FY2021. High slippages will drive elevated credit provisions as the bank expects to keep its NNPA's below the PCA threshold of 6%.

Weak operating profitability and elevated credit cost could drive losses in FY2021 as well – Despite the reduction in the cost of interest-bearing funds for IOB, the net interest margin (NIM), as a percentage of average total assets (ATA), remained weaker at 2.1% in FY2020 (against the PSB average of 2.4%) because of its low credit-to-deposit ratio. This, in turn, resulted from the bank's weak capital position and the high share of non-earning assets. Further, the scale of operations remains sub-optimal, given the declining loan book over the last many years. This has led to an elevated cost-to-income ratio of ~59.7% compared to ~56% for PSBs in FY2020. Accordingly, IOB's core operating profitability remained weak at ~1.2% of ATA compared to the PSBs' average of ~1.5% in FY2020. The weak operating profitability also impacts the bank's ability to absorb credit costs, which remained high at ~4.4% of ATA in FY2020. As a result, the core profit before tax remained weak at -3.3% of ATA in FY2020. Going forward, ICRA expects that the credit costs could remain high at ~1.3-1.8% of ATA in FY2021, resulting in a high likelihood of losses in FY2021 as well with a return on assets (RoA) of 0.0 - (0.4)% of ATA.

Large capital requirements to exit PCA framework and turn around operations – Despite a capital infusion of ~Rs. 19,974 crore during FY2018-2020, IOB's capital position remains weak driven by the huge loss of ~Rs. 18,565 crore during this period. The bank reported a Tier I of 8.36% as on September 30, 2020, which was lower than the regulatory capital requirement of 8.875% (including CCB of 1.875%). With a scheduled increase in the regulatory Tier I requirement to 9.5% by April 1, 2021 and the expectation of losses, ICRA expects the bank's capital requirement to remain high if it endeavours to exit the PCA framework. However, the capital requirement is expected to be comparatively lower at less than Rs. 1,000 crore if the bank were to maintain the regulatory capital ratios without the CCBs. IOB is likely to remain constrained on capital and could remain in capital-conservation mode by degrowing its loan book. This could further affect its operating profitability, though the same would be partly offset by the reducing cost of funds.

Liquidity position: Strong

IOB has a strong liquidity profile with a liquidity coverage ratio of 242.45% for Q2 FY2021 against the regulatory requirement of 100% from January 1, 2019. Moreover, the bank maintained an excess SLR of ~4.9% of the average net demand and time liabilities (NDTL) on a monthly average basis in FY2020. As IOB is weak on the capital front, it has deployed sizeable surpluses in Government securities and reverse repo balances, driving positive cumulative mismatches across all buckets up to 1 year as per the structural liquidity statement as on June 30, 2020. ICRA expects IOB to maintain strong liquidity on the basis of its decreasing deposit concentration and improving core deposit base. The bank 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 requirement.

Rating sensitivities

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

Negative triggers – ICRA could downgrade the ratings in case of inadequate capital support from the GoI, leading to sustained capital breaches with a CRAR of less than 9.0%, which is also critical for servicing the rated Upper Tier-II bonds.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA 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 the demonstrated track record of capital infusion by the GoI. ICRA expects the GoI to support IOB with capital infusions, if required.
Consolidation/Standalone	To arrive at the ratings, ICRA has considered the standalone financials of IOB. However, in line with ICRA's limited consolidation approach, the capital requirement of the bank's key subsidiaries has been factored in.

About the company

Indian Overseas Bank is a public sector bank with a market share of ~1.2% of the advances and ~1.7% of the deposits in the banking sector with the Government of India having a majority ownership (95.84% as on September 30, 2020). The bank's market share has steadily declined from ~2.5% of advances and ~2.7% of deposits as on March 31, 2015, given its weak asset quality, earnings, and capital position. As on September 30, 2020, IOB had an asset base (net of revaluation reserve) of about Rs. 3.13 lakh crore and a network of 3,221 branches.

IOB reported a net loss of Rs. 8,528 crore in FY2020 (net loss of Rs. 3,737 crore in FY2019) on a total asset base of Rs. 2.58 lakh crore as on March 31, 2020 (Rs. 2.48 lakh crore as on March 31, 2019), translating into an RoA of -3.4% for FY2020 and -1.5% for FY2019. For H1 FY2021, the bank reported a net profit of Rs. 269 crore (loss of Rs. 2,596 crore in H1 FY2020) on a total asset base of Rs. 3.13 lakh crore as on September 30, 2020 (Rs. 2.49 lakh crore as on September 30, 2019), translating into an RoA of 0.2% and -2.1%, respectively.

Key financial indicators - Standalone

(Rs. crore)	FY2019	FY2020	H1 FY2020	H1 FY2021
Net interest income	5,279	5,303	2,492	2,974
Profit before tax	(5,959)	(8,345)	(2,580)	279
Profit after tax	(3,737)	(8,528)	(2,596)	269
Net advances – Rs. lakh crore	1.33	1.21	1.27	1.23
Total assets* - Rs. lakh crore	2.48	2.58	2.49	3.13
% CET I	7.82%	8.21%	9.20%	8.36%
% Tier I	7.82%	8.21%	9.20%	8.36%
% CRAR	10.20%	10.72%	11.86%	10.90%
% Net interest margin / Average total assets	2.14%	2.10%	2.01%	2.08%
% Net profit / Average total assets	(1.52%)	(3.37%)	-2.09%	0.19%
% Return on net worth	(30.10%)	(61.57%)	-41.28%	3.86%
% Gross NPAs	22.0%	14.8%	20.00%	13.04%
% Net NPAs	10.8%	5.4%	9.84%	4.30%
% Provision coverage excl. technical write-offs	57.0%	66.8%	56.4%	70.0%
% Net NPA / Core equity	149.9%	70.8%	112.9%	56.7%

*Total assets and net worth exclude revaluation reserves

Source: Indian Overseas Bank, ICRA research

All calculations as per ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: Not applicable

Rating history for past three years

Rating (FY2021)					Rating History for the Past 3 Years						
	Instrument	Type	Rated Amount	Amount Outstanding	Current Rating	FY2021	FY2020	FY2019			FY2018
					29-Dec-2020	12-Oct-20	20-Dec-19	24-Oct-18	14-Aug-18	14-Jun-18	24-Nov-17
1	Basel III Tier-II Bonds	Long Term	300.00	300.00	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	-	-	-
		Long Term	500.00	500.00	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)
			300.00	300.00	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)	[ICRA]A+ (Hyb) (Negative)
2	Basel II Lower Tier-II Bonds	Long Term	1000.00	1000.00	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
		Long Term	290.00	-	-	-	[ICRA]A+ (Negative); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
		Long Term	300.00	-	-	-	-	[ICRA]A+ (Negative); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
		Long Term	500.00	-	-	-	-	-	-	-	-
3	Certificates of Deposit	Short Term	15000.00	-	-	[ICRA]A1+; withdrawn	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
4	Basel II 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)	[ICRA]A- (Negative)
		Long Term	655.30	-	-	-	-	[ICRA]A- (Negative); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)
		Long Term	510.00	-	-	-	[ICRA]A- (Negative); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)
		Long Term	500.00	-	-	-	-	-	-	-	-
5	Basel II Perpetual Bonds	Long Term	300.00	-	-	-	[ICRA]A- (Negative); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)
		Long Term	80.00	-	-	-	-	-	-	-	-
		Long Term	400.00	-	-	-	-	-	-	-	-

Amount in Rs. crore

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	Amount Rated (Rs. crore)	Current Rating and Outlook
INE565A09256	Basel III Tier-II Bonds	3-Nov-16	9.24%	3-Nov-26	800.00	[ICRA]A+(hyb)(Negative); reaffirmed
INE565A09264		10-Dec-18	11.70%	10-Dec-28	300.00	[ICRA]A+(hyb)(Negative); reaffirmed
INE565A09215	Basel II Lower Tier-II Bonds	31-Dec-10	8.95%	31-Dec-20	1,000.00	[ICRA]A+(Negative); reaffirmed
INE565A09223	Basel II Upper Tier-II Bonds	10-Jan-11	9.00%	10-Jan-26 [#]	967.00	[ICRA]A-(Negative); reaffirmed

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

Source: Indian Overseas Bank

Key features of the rated instruments

The servicing of the Basel II Lower Tier-II Bonds is not subject to any capital ratios and profitability. However, the Basel III Tier-II Bonds are expected to absorb losses once the point of non-viability (PONV) trigger is invoked. The letters 'hyb' in parenthesis, suffixed to a rating symbol, stand for hybrid, indicating that the rated instrument is a hybrid subordinated instrument with equity-like loss-absorption features. Such features may translate into higher loss severity vis-à-vis conventional debt instruments. The rated Tier-II bonds are expected to absorb losses once the PONV trigger is invoked.

The Basel II Upper Tier-II Bonds have specific features wherein the debt servicing is linked to the bank meeting the profitability and regulatory norms for capitalisation. As per the regulatory norms for these instruments, approval from the RBI is required for coupon payments (including redemption) 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%. The coupon, if missed on the Basel II Upper Tier-II Bonds, is cumulative, if not paid.

Annexure-2: List of companies where limited consolidation has been used to arrive at the ratings

S. No.	Name of the entity	Ownership	Consolidation Approach
1.	India International Bank (Malaysia)	35.00%	Limited Consolidation
2.	Odisha Gramya Bank	35.00%	Limited Consolidation
3.	Universal Sompo General Insurance	18.06%	Limited Consolidation

Source: Indian Overseas Bank, ICRA research

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