March 14, 2022

Indian Overseas Bank: Rating reaffirmed; outlook changed to Positive from Stable; rating withdrawn for Rs. 500 crore Basel III Tier II bonds programme

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+ (Positive) reaffirmed; outlook changed to Positive from Stable
Basel III Tier II Bonds	500.00	-	[ICRA]A+ (Positive) reaffirmed and withdrawn; outlook changed to Positive from Stable
Total	**1,600.00**	**1,100.00**	

**Instrument details are provided in Annexure-1*

Rationale

The revision in outlook factors in an improvement in the bank's capitalisation, earning and solvency[1] profile. Supported by the capital infusion, higher provisions on legacy stressed assets, the solvency profile for the bank has improved over the past few years. With improving provisions on legacy non-performing assets (NPAs), ICRA expects the internal capital generation to remain better than past, which shall result in limited dependence on capital from Government of India (GoI) going forward.

The rating reaffirmation takes into account Indian Overseas Bank's (IOB) sovereign ownership and the GoI's demonstrated track record of capital infusion into the bank. In this regard, the GoI has infused equity capital of Rs. 24,074 crore into the bank during FY2018-FY2022 through recapitalisation bonds including the recent infusion of Rs. 4,100 crore through zero coupon bonds (ZCBs) in March 2021. Supported by the capital infusion as well as operating profits, the bank increased the provision cover on its stressed assets while improving the capital ratios, which also enabled the bank to exit the prompt corrective action (PCA) framework of the Reserve Bank of India (RBI) in September 2021. Even adjusting the ZCBs for fair value, as per ICRA's estimates, the capital and solvency profile is likely to remain better than past and the negative rating triggers. Further, 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 rating, however, remains constrained by the weak asset quality as reflected in high gross slippage rate and modest profitability. The asset quality stress because of the Covid-19 pandemic has resulted in a high level of standard restructured advances. Accordingly, the performance of the restructured book will remain key driver for fresh slippages and profitability. Given the high provision cover on legacy stressed assets and decline in net NPAs (NNPAs), ICRA expects that the bank is likely to significantly absorb the credit provisions from its operating profits, thereby translating in limited capital dependence on GoI, going forward. We expect GoI could further infuse some capital into the bank to further strengthen the capital position of the bank, though the same may not be as large as in the recent past.

ICRA has withdrawn the rating assigned to the Rs. 500.00-crore unplaced Basel III Tier II Bonds at the request of the bank. The rating was withdrawn in accordance with ICRA's policy on the withdrawal and suspension of credit ratings (click here for the policy).

[1] *Solvency ratio = Net Stressed Assets / Core Capital; net stressed assets include Net NPAs, net non-performing investments and net security receipts*

Key rating drivers and their description

Credit strengths

Sovereign ownership with demonstrated capital support from GoI – IOB has majority sovereign ownership with the GoI's equity stake in the bank at 96.38% as of December 31, 2021. It received Rs. 4,100 crore of capital infusion in FY2021 as a part of the GoI's Rs. 20,000-crore recapitalisation plan for PSBs (through ZCBs). These ZCBs accounted for ~28% of the core capital and the adjusted Tier-I (adjusted for the fair value of these bonds) is estimated (~12%[2]) to remain above the regulatory minimum requirement of 9.5% as on December 31, 2021. While the bank may not require further capital, however we expect GoI could further infuse some capital into the bank to further strengthen the capital position of the bank, though the same may not be as large as in the recent past. Further, as a part of the Union Budget, the GoI had proposed the divestment of two public sector banks (PSBs) and the rating will be reassessed in case of a change in the sovereign ownership.

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 3,214 as on December 31, 2021. While the branch network has been declining over the last few years as the bank has been shutting down loss-making branches, its deposit base has remained stable at Rs. 2.1-2.5 lakh crore over the last 4-5 years, given the limited credit growth owing to inclusion in PCA framework. 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 42.5% as on December 31, 2021 from 40.9% as on December 31, 2020 (26.3% as on December 31, 2015). However, the improvement was driven by the limited credit growth pursued by the bank because of its weak capital position. Improving share of core deposits continues to drive IOB's strong liquidity profile, though the same is also driven by the low credit-to-deposit ratio because of capital constraints and inclusion in PCA framework in the past.

Credit challenges

Asset quality remains weak as slippages remain elevated – IOB's asset quality remains weak with gross fresh slippages of Rs. 4,058 crore (4.4% of standard advances) on an annualised basis in 9M FY2022 (2.8% in FY2021 and 6.1% in FY2020). Despite elevated slippage rate because of stress induced by Covid-19, the bank has been able to reduce its NNPAs to 2.6% as on December 31, 2021 (3.6% as on March 31, 2021 and 5.4% as on March 2020), which was supported by accelerated provisions on its stressed assets as well as various regulatory forbearance including one-time restructuring scheme of RBI. The standard restructured book is estimated at over 6.0% of standard advances as on December 31, 2021. The full impact of the pandemic is still evolving, and the overall asset quality will remain monitorable for the performance of these accounts.

Earnings profile likely to remain average – IOB's core operating profits (excluding gain on bond portfolio) stood at 1.8% (annualised) of ATA in 9M FY2022 and 1.5% in FY2021, which is largely comparable with the PSB average of 1.6% in FY2021. Given the sizeable pool of gross NPAs, the recoveries from the stressed accounts has also supported the profitability for the bank during FY2021 and 9MFY2022. With decline in NNPAs and hence the legacy provisions going forward, we expect that the bank will largely absorb the majority of incremental credit provisions through its core operating profits and expect that the return on assets (RoA) is likely to remain positive going forward, however this is likely to result in modest RoA of <0.4% over next couple of years.

Modest capitalisation and solvency profile – Driven by the capital infusion in FY2021 and the profits generated during the trailing 12 months ending December 31, 2021, IOB's reported CET-I/Tier-I and solvency ratio improved to 12.9% and 36.2%, respectively, as on December 31, 2021 from 8.8% and 60.6%, respectively, as on December 31, 2020. Adjusted for fair valuation of ZCBs and including the 9MFY2022 profits, the Tier-I capital position and solvency is estimated at ~12% and ~39% respectively. We don't envisage sizeable capital infusion from GoI going forward as was the case in the past. This coupled with expectations of modest incremental capital generation and growth led capital consumption could lead to capital cushions at Tier-I remaining limited over regulatory requirements of 9.5%.

[2] *Including 9MFY2022 profit*

Liquidity position: Strong

IOB's liquidity profile remains supported by the high SLR and reverse repo balances, driving a strong liquidity coverage ratio (LCR) of 176.9% for Q2 FY2022 (daily average) against the regulatory requirement of 100% from January 1, 2019. As on December 31, 2021, IOB maintained cash and investments of 44% of total assets. Supported by its sovereign ownership and deposit franchise, ICRA expects IOB to roll over its deposits upon maturity and maintain its liquidity profile. The bank can also avail liquidity support from the RBI (through reverse repo against excess SLR investments and marginal standing facility mechanism) in case of urgent liquidity needs.

Rating sensitivities

Positive factors – ICRA could upgrade the rating if the bank is able to sustain improved internal capital generation with RoA of over 0.3% and maintain its solvency profile with net stressed assets/core equity better than 60%, while maintaining capital cushions of >75bps over the regulatory Tier I level (including capital conservation buffer; CCB) on a sustained basis.

Negative factors – Given the Positive outlook, the rating is unlikely to be downgraded. However, the rating will be reassessed in case of a change in the sovereign ownership. ICRA could revise the outlook to Stable if the asset quality or capitalisation profile deteriorates, thereby resulting in the weakening of the solvency profile with the solvency becoming weaker than the 70% level on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Rating Methodology for Banks Impact of Parent or Group Support on an Issuer's Credit Rating ICRA's Policy on Withdrawal of Ratings
Parent/Group Support	The ratings factor in IOB's sovereign ownership and the demonstrated track record of capital infusions 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

Established in 1937, IOB is a public sector bank (PSB) with the GoI holding an equity stake of 96.38% in the bank as on December 31, 2021 (95.84% as on March 31, 2020). As on December 31, 2021, the bank had a well-established network of 3,214 branches.

IOB reported a profit after tax of Rs. 1,157 crore in 9M FY2022 against a profit after tax of Rs. 832 crore in FY2021. Its asset quality indicators, i.e. GNPA% and NNPA%, stood at 10.4% and 2.6%, respectively, as on December 31, 2021 compared to 11.7% and 3.6%, respectively, as on March 31, 2021. The capitalisation metrics, i.e. CET-I and Tier-I, stood at 12.9% and 12.9%, respectively, as on December 31, 2021 compared to 12.9% and 12.9%, respectively, as on March 31, 2021.

Key financial indicators (standalone)

Indian Overseas Bank	FY2020	FY2021	9M FY2022
Net interest income (Rs. crore)	5,303	5,899	4,702
Profit before tax (Rs. crore)	(8,345)	840	1,179
Profit after tax (Rs. crore)	(8,528)	832	1,157
Net advances (Rs. lac crore)	1.2	1.3	1.4
Total assets* (Rs. lac crore)	2.6	2.7	2.8
% CET-I	8.2%	12.9%	12.9%
% Tier-I	8.2%	12.9%	12.9%
% CRAR	10.7%	15.3%	15.4%
% Net interest margin / Average total assets	2.1%	2.2%	2.3%
% Net profit / Average total assets	(3.4%)	0.3%	0.6%
% Return on net worth	(61.6%)	5.1%	8.0%
% Gross NPAs	14.8%	11.7%	10.4%
% Net NPAs	5.4%	3.6%	2.6%
% Provision coverage excl. technical write-offs	66.8%	72.0%	76.8%
% Net NPA / Core equity	70.8%	31.7%	24.7%

**Total assets and net worth exclude revaluation reserves*
Source: *IOB, ICRA Research*
^ Annualised
All calculations as per ICRA Research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2022)				Chronology of Rating History for the past 3 years						
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating in FY2022	Date & Rating in FY2021			Date & Rating in FY2020	Date & Rating in FY2019		
					Mar-14-22	Mar-16-21	Dec-29-20	Oct-12-20	Dec-20-19	Oct-24-18	Aug-14-18	Jun-14-18
1	Basel III Tier II Bonds	LT	800.00	800.00	**[ICRA]A+ (Positive)**	[ICRA]A+ (hyb) (Stable)	[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+ (Positive)**	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	-	-
			500.00	-	**[ICRA]A+ (Positive); withdrawn**	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	-	-	-	-	-
2	Basel II Lower Tier II Bonds	LT	1000.00	-	-	[ICRA]A+ (Stable); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
			290.00	-	-	-	-	-	[ICRA]A+ (Negative); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
			300.00	-	-	-	-	-	-	[ICRA]A+ (Negative); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
3	Basel II Upper Tier II Bonds	LT	967.00	-	-	[ICRA]A- (Stable); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)
			655.30	-	-		-	-	-	[ICRA]A- (Negative); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)
			510.00	-	-		-	-	[ICRA]A- (Negative); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)	[ICRA]A- (Negative)
			500.00	-	-		-	-	-	-	-	-
4	Basel II Perpetual Bonds	LT	300.00	-	-	-	-	-	-	[ICRA]A- (Negative); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)
			80.00	-	-	-	-	-	-	-	-	-
			400.00	-	-	-	-	-	-	-	-	-

Removal of (hyb) suffix from Basel III instruments

In compliance with the circular issued by the Securities and Exchange Board of India (SEBI) on July 16, 2021 for standardising the rating scales used by credit rating agencies, ICRA has discontinued its practice of affixing the (hyb) suffix alongside the rating symbols for hybrid instruments. Accordingly, ICRA has removed the (hyb) suffix that was earlier being placed alongside the rating symbol for the hybrid instruments issued by IOB. The earlier and revised denotation of the rating for various instruments can be seen in the table above. This rating action only involves the removal of the (hyb) suffix and should not be construed as a change in the credit rating.

Complexity level of the rated instrument

Instrument	Complexity Indicator
Basel III Tier II Bonds	Highly Complex

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional, or legal aspects. Details on the complexity levels of the instruments are available on ICRA’s 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
INE565A09256	Basel III Tier II Bonds	Nov-03-16	9.24%	Nov-03-26@	800.00	[ICRA]A+ (Positive)
INE565A09264		Dec-10-18	11.70%	Dec-10-28^	300.00	[ICRA]A+ (Positive)
Unplaced		-	-	-	500.00	[ICRA]A+ (Positive); withdrawn

Source: *Indian Overseas Bank*

@Call option can be exercised by the bank at the end of 5 years (or on any coupon payment date thereafter) after approval from the RBI

^ Call option can be exercised by the bank at the end of 5 years (or on any coupon payment date thereafter) after approval from the RBI

Key features of rated debt instruments

The servicing of the Basel III Tier II bonds is not subject to any capital ratios and profitability. However, these bonds are expected to absorb losses once the point of non-viability (PONV) trigger is invoked. Further, the exercise of the call option on the Basel III Tier II bonds is contingent upon the prior approval of the Reserve Bank of India (RBI) and the bank will also need to demonstrate that the capital position is well above the minimum regulatory requirement post the exercise of the said call option.

Annexure-2: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
India International Bank (Malaysia)	35.00%	Limited Consolidation
Odisha Gramya Bank	35.00%	Limited Consolidation
Universal Sompo General Insurance	18.06%	Limited Consolidation

Source: *Indian Overseas Bank, ICRA Research*

ANALYST CONTACTS

Mr. Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Mr. Anil Gupta
+91 124 4545 314
anilg@icraindia.com

Mr. Hemant Sultania
+91 124 4545 386
hemant.sultania@icraindia.com

Mr. Aayush Behal
+91 124 4545 300
aayush.behal@icraindia.com

RELATIONSHIP CONTACT

Mr. L. Shivakumar
+91 22 6114 3406
shivakumar@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

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ICRA Limited

Registered Office

B-710, Statesman House, 148, Barakhamba Road, New Delhi-110001
Tel: +91 11 23357940-45

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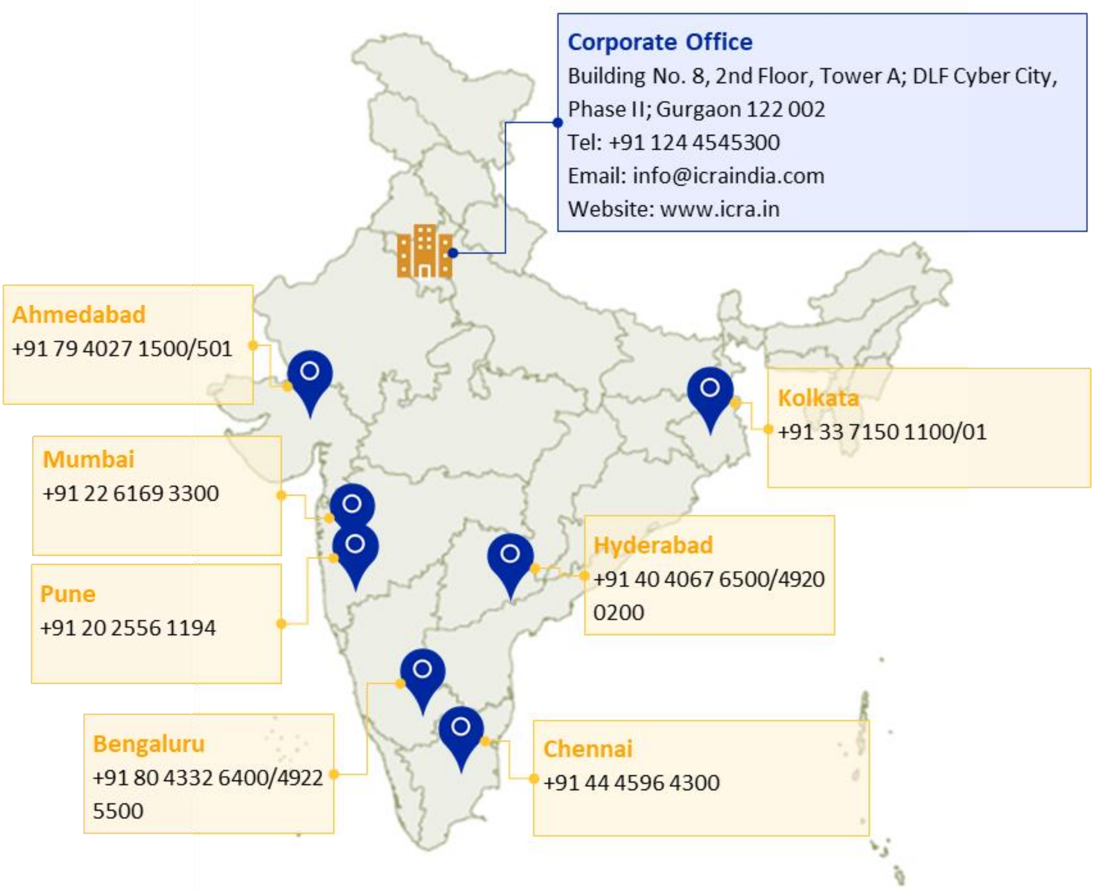

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