November 28, 2023

Indian Overseas Bank: Rating reaffirmed; Outlook revised to Positive

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Tier II Bonds	1,300.00	1,300.00	[ICRA]AA- (Positive); Reaffirmed and outlook revised to Positive from Stable
Total	**1,300.00**	**1,300.00**	

**Instrument details are provided in Annexure I*

Rationale

The revision in the outlook on the long-term rating of Indian Overseas Bank's (IOB) factors in the sustained improvement in its solvency[1] profile, capital position and profitability levels. This was driven by the reduction in legacy stressed assets, leading to lower credit costs and a consequent improvement in the core and net operating profitability.

The rating continues to be supported by IOB's sovereign ownership and the Government of India's (GoI) demonstrated track record of capital infusion into the bank. The GoI had infused equity capital of Rs. 24,074 crore into the bank during FY2018-FY2022 through recapitalisation bonds. ICRA expects the bank to remain sufficiently capitalised with no need for regulatory or growth capital in the near term. However, the impact of transitioning to provisioning, based on the expected credit loss (ECL) framework, on its capital and profitability levels will remain a monitorable.

Further, the bank's deposit base remains stable with the improving share of core deposits supported by a well-established deposit franchise. This continues to drive its strong liquidity profile.

The rating also takes note of the vulnerable book (SMA-12, SMA-2 and standard restructured book), which has moderated meaningfully from the much higher level a year ago. However, the performance of the residual vulnerable book as well as the impact of any macro-economic shock on the bank's asset quality and profitability profile will remain monitorable.

The Positive outlook on the rating factors in ICRA's expectation that IOB will continue to maintain the improvement in its earnings profile and asset quality levels, while ensuring that the solvency levels remain better than the negative triggers.

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 September 30, 2023. The GoI had infused equity capital of Rs. 24,074 crore into the bank during FY2018-FY2022 through recapitalisation bonds, including Rs. 4,100 crore in the form of zero coupon bonds (ZCBs[3]) in March 2021. This enabled the bank to increase its provision cover on legacy stressed assets, while improving its capital ratios above the regulatory levels, and helped it exit the Reserve Bank of India's (RBI) prompt corrective action (PCA) framework in September 2021. Going forward, a sustained improvement in internal capital generation is likely to limit the near-term requirement of capital support from the GoI.

[1] Solvency ratio = Net stressed assets / Core capital; net stressed assets include NNPAs, net non-performing investments and net security receipts
[2] SMA is defined as a special mention account (SMA), which is an account exhibiting signs of incipient stress resulting in the borrower defaulting in the timely servicing of their debt obligations though the account has not yet been classified as an NPA as per the extant RBI guidelines; SMA-1 accounts are overdue by 31-60 days while SMA-2 accounts are overdue by 61-90 days
[3] These ZCBs were issued at face value and are redeemable at face value after the 10-15th year from issuance; accordingly, the fair value is lower than the face value. IOB has accounted for these ZCBs at fair value from its March 2022 financials

Well-developed deposit franchise and strong liquidity position – IOB has a long-standing presence and an established retail franchise in South India with a total branch network of 3,223 as on September 30, 2023. Its steady deposit base is supported by current account savings account (CASA) deposits, which accounted for 43.65% of the bank's overall deposits as of September 2023 (42.76% as of September 2022), remaining broadly in line with the public sector banks' (PSBs) average. Further, the reliance on bulk deposits reduced to at 5.1% as of September 2023, which is lower than the high levels observed in the past (~21 % as of March 2022).

Besides the high share of CASA deposits, the share of the top 20 depositors in total deposits remained low at 5.18% as on March 31, 2023. The granular deposit base and the high share of CASA deposits continue to strengthen the bank's resource and liquidity profile.

Strong capitalisation and solvency profile – The bank's core equity capital (CET-I)/Tier-I witnessed a sustained improvement and stood at 13.81%[4] as on September 30, 2023 vis-à-vis 12.11% as on September 30, 2022 (12.84% as on September 30, 2021). While the capitalisation profile was supported by infusions in the past, IOB remained profitable during FY2021-H1 FY2024, leading to healthy internal capital generation. With the increase in the provision cover ratio on stressed assets, the solvency level improved to 7.52% as on September 30, 2023 from 32.4% as on September 30, 2022 (38.1% as on September 30, 2021). Given the high provision cover on legacy stressed assets and the decline in the net non-performing advances (NNPAs), ICRA expects that the internal capital generation is likely to be sufficient for growth as well as for maintaining adequate cushion over the regulatory capital requirements. Furthermore, the impact stemming from the recent regulatory measures towards lending to consumer credit and banking credit to non-banking financial companies (NBFCs) is largely expected to remain at a manageable level of less than 50 basis points (bps) of the CET.

The Reserve Bank of India (RBI) recently issued a discussion paper for transitioning to the expected loss framework for credit exposures. As highlighted by ICRA, banks with a high share of overdue/restructured loans could see a one-time impact on their capital position upon transitioning. While the RBI has proposed that these provisions should be spread over a five-year period for the computation of the regulatory capital ratios, the impact on the capital position (without taking regulatory forbearance) will remain a monitorable.

Earnings profile improves – With better asset quality levels leading to lower interest reversals compared to the past as well as the improving scale, the bank reported an operating profit of 1.91% of average total assets (ATA) in H1 FY2024 (2.07% in FY2023, 1.86% in FY2022). Despite recoveries/upgrades being higher than the overall slippages in H1 FY2024, the credit cost remained elevated as IOB continued to shore up its provision cover on stressed assets/legacy NPAs. This led to a modest return on assets (RoA) of 0.70% in H1 FY2024 although it remained on an improving trajectory compared to 0.60% in H1 FY2023 (0.51% in H1 FY2022). With legacy NPAs largely provided for, ICRA expects the profitability to improve on the back of low credit costs resulting from better asset quality.

Credit challenges

Asset quality remains monitorable – The annualised fresh NPA generation rate moderated to 1.01% of standard advances in H1 FY2024 from the much higher levels in the past (3.18% in FY2023, 4.09% in FY2022, 2.77% in FY2021). Apart from this, healthy recoveries/upgrades and significant write-offs in FY2023 and H1 FY2024 supported the steep decline in the gross NPA (GNPA) level to 4.74% as on September 30, 2023 from 8.53% as on September 30, 2022. As the bank's provision coverage ratio gradually increased to 86.2% (excluding written-off accounts) as on September 30, 2023 from 71.8% as on September 30, 2022, the NNPA level also moderated to 0.68% from 2.56% during this period.

Despite the meaningful improvement in the headline asset quality metrics, the overdue loan accounts, as indicated by SMA-1 and SMA-2, as well as standard restructured advances remain relatively elevated even though the same has moderated from the higher levels during the Covid-19 pandemic. The performance of this vulnerable pool and the impact of macro-economic shocks on the servicing abilities of many borrowers will be key monitorable factors where the asset quality is concerned.

Environmental and social risks

[4] *Including interim profits*

While banks like IOB do not face material physical climate risks, they are exposed to environmental risks indirectly through their portfolio of assets. If the entities or businesses, to which banks and financial institutions have an exposure, face business disruptions because of physical climate adversities or if such businesses face climate transition risks because of technological, regulatory or customer behaviour changes, it could translate into credit risks for banks. However, such risk is not material for IOB as it benefits from adequate portfolio diversification. Further, the lending is typically short-to-medium term, allowing it to adapt and take incremental exposure to businesses that face relatively fewer downside environmental risks.

With regard to social risks, data security and customer privacy are among the key sources of vulnerability for banks as material lapses could be detrimental to their reputation and invite regulatory censure. IOB has not faced material lapses over the years. Customer preferences are increasingly shifting towards digital banking, which provides an opportunity to reduce the operating costs. IOB has been making the requisite investments to enhance its digital interface with its customers. While it contributes to promoting financial inclusion by lending to the underserved segments, its lending practices remain prudent as reflected in the healthy asset quality numbers in this segment compared with its peers.

Liquidity position: Strong

IOB's liquidity profile is strong, supported by its strong retail liability franchise and excess statutory liquidity ratio (SLR) holdings of 5.76% of total deposits as on June 30, 2023. Moreover, the liquidity coverage ratio remained comfortable at 153.1% and the net stable funding ratio was 141.5% for the year ending September 30, 2023, against the regulatory requirement of 100%. The bank can also avail liquidity support from the RBI (through repo against excess SLR investments and marginal standing facility mechanism) in case of urgent liquidity needs. Supported by its sovereign ownership, healthy liabilities profile and excess SLR holdings, ICRA expects IOB to continue maintaining a strong liquidity profile.

Rating sensitivities

Positive factors – ICRA could upgrade the rating if the bank is able to sustain its profitability, capital cushions and solvency with an RoA of more than 0.5%, capital cushions of more than 100 bps and solvency that is better than 30%.

Negative factors – The rating will be reassessed in case of a change in the sovereign ownership. ICRA could also revise the outlook to Stable and/or downgrade the rating if the asset quality or capitalisation profile deteriorates, thereby weakening the solvency profile with net stressed assets/core equity exceeding 70% on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	ICRA's Rating Methodology for Banks and Financial Institutions Impact of Parent or Group Support on an Issuer's Credit Rating Rating Approach – Consolidation
Parent/Group support	The rating factors in IOB's sovereign ownership and the demonstrated track record of capital infusions by the GoI. ICRA expects the GoI to support the bank with capital infusions, if required.
Consolidation/Standalone	For arriving at the rating, ICRA has considered the standalone financials of IOB. However, in line with ICRA's consolidation approach, the capital/funding requirement of the Group's various subsidiaries/joint ventures, going forward, 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% as on September 30, 2023 (95.84% as on March 31, 2020). As on September 30, 2023, the bank had a well-established network of 3,223 branches.

IOB reported a profit after tax of Rs. 1,125 crore in H1 FY2024 against Rs. 894 crore in H1 FY2023. Its asset quality indicators, i.e. gross NPA (GNPA) and net NPA (NNPA), stood at 4.74% and 0.68%, respectively, as on September 30, 2023 compared to 8.53% and 2.56%, respectively, as on September 30, 2022. The capitalisation metrics, i.e. CET-I/Tier-I and CRAR, stood at 13.81% and 17.00%, respectively, as on September 30, 2023, compared to 12.11% and 15.14%, respectively, as on September 30, 2022.

Key financial indicators (standalone)

Indian Overseas Bank	FY2022	FY2023	H1 FY2023	H1 FY2024
Net interest income	6,311	8,255	3,707	4,669
Profit before tax	1,779	2,099	902	1,140
Profit after tax	1,710	2,099	894	1,125
Net advances (Rs. lakh crore)	1.4	1.8	1.6	2.0
Total assets (Rs. lakh crore)	3.0	3.1	3.0	3.3
CET-I/Tier-I	10.7%	12.9%	12.1%*	13.8%*
CRAR	13.8%	16.1%	15.1%*	17.0%*
Net interest margin / Average total assets	2.2%	2.7%	2.5%^	2.9%^
Net profit / Average total assets	0.6%	0.7%	0.6%^	0.7%^
Return on net worth	8.4%	9.9%	8.6%^	9.8%^
Gross NPAs	9.8%	7.4%	8.5%	4.7%
Net NPAs	2.7%	1.8%	2.6%	0.7%
Provision coverage excl. technical write-offs	75.2%	76.8%	71.8%	86.2%
Net NPA / Core equity	30.8%	19.5%	28.1%	7.5%

Total assets and net worth exclude revaluation reserves
Source: IOB, ICRA Research; Amount in Rs. crore unless mentioned otherwise
^ Annualised
**Including H1 profit*
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 (FY2024)				Chronology of Rating History for the Past 3 Years					
		Type	Amount Rated	Amount Outstanding	Date & Rating in FY2024	Date & Rating in FY2023		Date & Rating in FY2022	Date & Rating in FY2021		
			(Rs. crore)	(Rs. crore)	Nov-28-2023	Nov-30-2022	Nov-14-2022	Mar-14-2022	Mar-16-21	Dec-29-20	Oct-12-20
1	Basel III Tier II Bonds	LT	300.00	300.00	[ICRA]AA- (Positive)	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Positive)	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)
			-	-	-	-	[ICRA]AA- (Stable); withdrawn	[ICRA]A+ (Positive)	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)
			-	-	-	-	-	[ICRA]A+ (Positive); withdrawn	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	-
			1,000.00	1,000.00	[ICRA]AA- (Positive)	[ICRA]AA- (Stable)	-	-	-	-	-
2	Basel II Lower Tier II Bonds	LT	-	-			-	-	[ICRA]A+ (Stable); withdrawn	[ICRA]A+ (Negative)	[ICRA]A+ (Negative)
3	Basel II Upper Tier II Bonds	LT	-	-			-	-	[ICRA]A- (Stable); withdrawn	[ICRA]A- (Negative)	[ICRA]A- (Negative)
4	Certificates of Deposit	ST	-	-			-	-	-	-	[ICRA]A1+; withdrawn

LT – Long term; ST – Short term

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: [Click Here]

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date^	Amount Rated (Rs. crore)	Current Rating and Outlook
INE565A09264	**Basel III Tier II Bonds**	Dec-10-2018	11.70%	Dec-10-2028	300.00	[ICRA]AA- (Positive)
INE565A08050		Mar-24-2023	9.00%	Mar-24-2033	1,000.00	[ICRA]AA- (Positive)

Source: Indian Overseas Bank

^ Call option can be exercised by the bank at the end of 5 years 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 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 II: List of entities considered for consolidated analysis

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

Source: Indian Overseas Bank, ICRA Research

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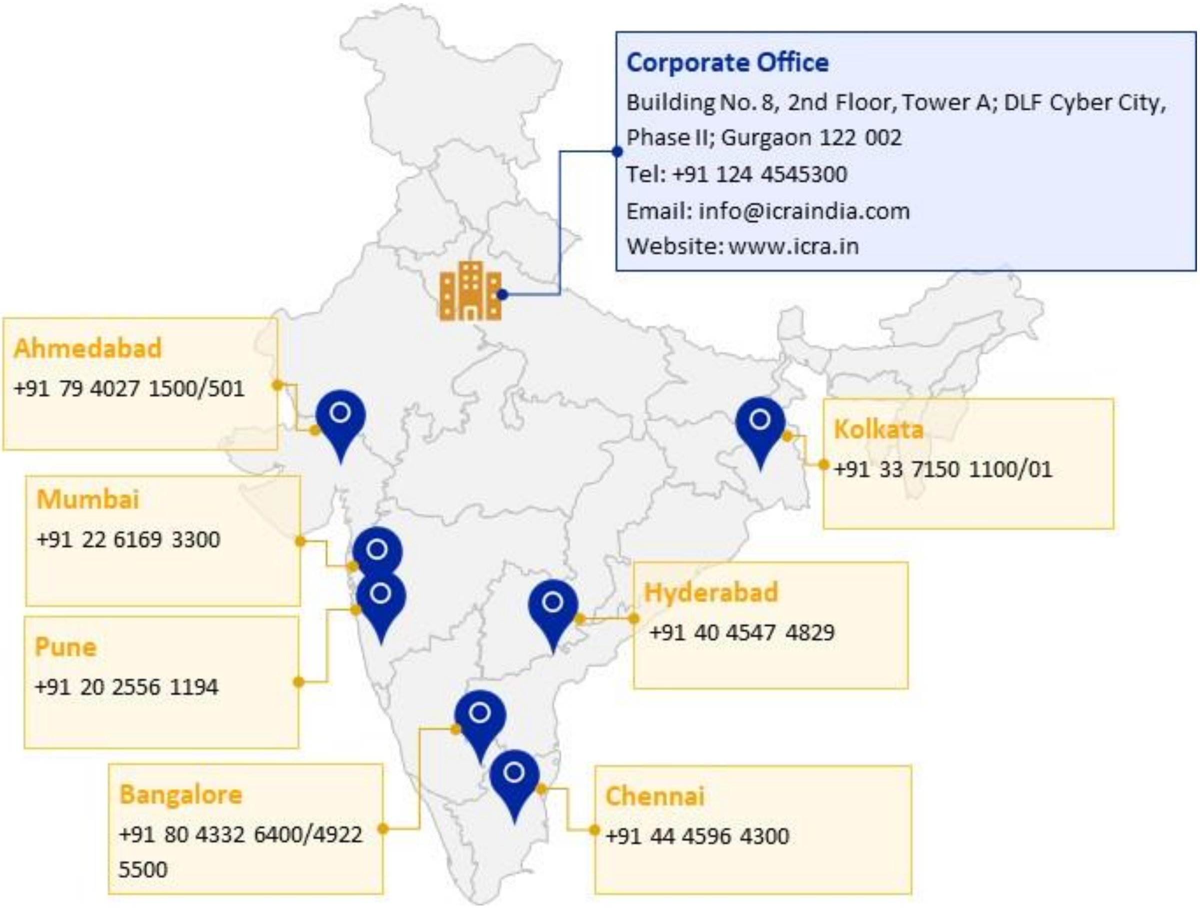

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