May 31, 2017

Oriental Bank of Commerce

Summary of Rated instruments

Instrument*	**Rated Amount (Rs. crore)**	**Rating Action**
Basel II compliant Upper Tier II Bonds	500	[ICRA]A+ (Negative); Downgraded from [ICRA]AA- (Negative)
Basel II compliant Lower Tier II Bonds	1,200	[ICRA]AA- (Negative); Downgraded from [ICRA]AA (Negative)
Basel II compliant Lower Tier II Bonds	500	[ICRA]AA (Negative) Rating Withdrawn
Basel III compliant Tier II Bonds	3,000	[ICRA]AA- (hyb) (Negative); Downgraded from [ICRA]AA (hyb) (Negative)
Basel III compliant Tier –I Bonds	2,000	[ICRA]A (hyb) (Negative); Downgraded from [ICRA]A+ (hyb) (Negative)
Total	6,700	

* *Instrument details in annexure*

Rating action

ICRA has downgraded the rating for the Rs. 1,200 crore Lower Tier II bonds programme of Oriental Bank of Commerce (OBC) to [ICRA]AA- (pronounced ICRA double A minus) from [ICRA]AA (pronounced ICRA double A)[†]. ICRA has also downgraded the rating for the Rs. 500 crore Upper Tier II bonds of OBC to [ICRA]A+ (pronounced ICRA A plus) from [ICRA]AA-. ICRA has withdrawn the rating assigned earlier to the Rs. 500 crore Lower Tier – II bonds as there is no amount outstanding against the rated instrument and these have been redeemed. The withdrawal is at the request of the bank.

ICRA has also downgraded the rating for OBC's Rs. 3,000 crore Basel III compliant Tier II bonds to [ICRA]AA- (hyb) (pronounced ICRA double AA minus hybrid) from [ICRA]AA (hyb) (pronounced ICRA double AA hybrid); and the ratings for the Rs. 2,000 crore Additional Tier – I bonds to [ICRA]A (hyb) (pronounced ICRA A hybrid) from [ICRA]A+ (hyb) (pronounced ICRA A plus).

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 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" trigger is invoked. The outlook on the long term ratings is Negative.

The rating for the Basel III compliant Tier I bonds is two notches lower than the Basel III complaint Tier II bonds of the bank as these instruments have the following loss absorption features that make them riskier.

[†] "For complete rating scale and definitions, please refer to ICRA's website (www.icra.in) or other ICRA rating publications please use TNR for footnotes also...

- The bank has the full discretion at all times to cancel distribution or payments and the cancellation of discretionary payments shall not be an event of default.
- The minimum capital conservation ratio applicable to banks may restrict the bank from servicing these Tier I bonds in case the Common Equity Tier-I (CET-I) falls below the limit prescribed by the RBI.

These Tier I bonds are expected to absorb losses through the write-down mechanism at the objective pre-specified trigger point fixed at the bank's (CET-I) ratio as prescribed by the RBI – 5.5% till March 2019 and thereafter 6.125% of total risk weighted assets of the bank or when the "Point of Non-Viability" trigger is breached in the RBI's opinion.

Basel III compliant Tier I bonds also have following features, which makes them riskier.

- Coupon payments, which are non-cumulative, are discretionary and the bank has the full discretion at all times to cancel coupon payments.
- Coupon can be paid out of current year profits. However, if current year profit is not sufficient, or, if the payment of coupon is likely to result in a loss, the coupon payment can be done through reserves and surpluses created through appropriation of profits (including statutory reserves). However, the coupon payment is subject to the bank meeting the minimum regulatory requirements for CET I, Tier I and total capital ratios (including capital conservation buffer, CCB) at all times as prescribed by the RBI under Basel III regulations.

Rationale

The ratings downgrade takes into account OBC's weak operating and financial performance in Q4FY2017 and FY2017, as reflected in its increasing non-performing assets (NPA) and losses during FY2017, leading to a weakening of its capitalisation and solvency levels. The ratings downgrade and negative outlook on the ratings are driven by ICRA's weak outlook on the bank's asset quality, profitability as well as the increasing capital requirements under Basel III and the limited headroom available to raise capital from non-government sources given the Government of India (GoI) ownership of 58.38% stake as on March 31, 2017.

The bank's gross NPAs (GNPAs) and net NPAs (NNPAs) increased to 13.73% and 8.96% respectively as on March 31, 2017 from 9.57% and 6.70% respectively as on March 31, 2016. The increase in NPAs has resulted in a decline in net interest income (NII) during FY2017 amid increasing operating expenses thereby resulting in lower core operating profits before provisions and trading profits. The deterioration of asset quality has also translated into high credit provisions which were only partly offset by the increase in non-interest income (mainly from treasury gain on government securities) thereby resulting in net losses during FY2017. For Q4FY2017 and FY2017, the bank reported net losses of Rs. 1,218 crore and Rs. 1,094 crore respectively.

The negative outlook on the ratings continues to reflect the weak outlook on the bank's asset quality and profitability; despite credit provisions of 2.47% of ATA during FY2017, the bank's weak advances[1] remain high at 13.74% of net advances as on March 31, 2017 (~14.6% as on March 31, 2016). With elevated credit provisions during FY2017, the bank's provision coverage ratio improved; however, it remains lower than the average for public sector banks (PSBs), and is expected to result in elevated credit costs and a pressure on profitability during FY2018 as well.

[1] Net NPAs + Standard restructured + SDRs and S4A (standard advances excluding standard restructured) as % of net advances

During FY2017, the bank did not raise any equity capital, nor did it receive any capital support from the GoI, which coupled with the losses and increasing NPA levels have resulted in a weakening of solvency levels with NNPA/net worth of 111% as on March 31, 2017 as compared with 74% as on March 31, 2016. This has also resulted in a weakening of the bank's CET level to 7.59% of risk weighted assets (RWA) as on March 31, 2017 as compared with 8.52% as on March 31, 2016. ICRA however notes that both the solvency and CET levels remain above the regulatory requirement. With increasing capital requirements under Basel III regulations, assuming a 5-10% growth in RWAs, OBC's total equity requirement remains large at Rs 3,000- 4,500 crore during FY2018 and FY2019, which is 60-90% of its current market capitalisation. ICRA notes that to maintain a minimum GoI shareholding of 51%, OBC will be significantly dependent on the GoI to meet its incremental equity capital requirement.

The ratings are supported by OBC's majority sovereign ownership and its strong franchisee in northern India which provides access to a wide customer base; and the increasing share of retail, agriculture and MSME (RAM) loans in the bank's overall portfolio leading to better granularity in asset profile. ICRA expects the GoI to infuse adequate capital to meet the requirements as per Basel III capital regulations. The bank's ability to resolve the stressed assets and raise capital to absorb credit costs and to meet the increasing capital requirements under Basel III will be the key rating sensitivities going forward.

Key rating drivers

Credit strengths

- Majority sovereign ownership and expectation of continued GoI support in the form of capital infusion to meet the regulatory capital levels
- Strong franchise in northern India, which provides access to a wide customer base and increasing share of RAM loans in asset portfolio

Credit weaknesses

- Weak asset quality with a high share of stressed assets
- Weak profitability outlook on account of elevated NPA levels and expectations of credit costs remaining high in near term
- Current capitalisation comfortable as against current regulatory requirement; however, future equity capital requirements remain high as the internal capital generation is expected to be under pressure
- Despite an improvement in CASA deposits during the last two years, a relatively lower CASA base in comparison to peers results in a higher cost of interest bearing funds

Description of key rating drivers:

OBC's asset quality deteriorated sharply over the last two years, subsequent to the asset quality review (AQR) directed by the RBI in H2FY2016. The bank's reported GNPAs increased to Rs. 22,859 crore (13.73%) as on March 31, 2017 from Rs. 14,702 crore (9.57%) as on March 31, 2016 and Rs. 8,558 crore (5.70%) as on September 30, 2015. Despite the sharp increase in GNPAs, the bank's fresh NPA generation rate remains high with fresh slippages at 12.23% (annualised) during Q4FY2017 and 8.8% during FY2017 (7.38% in FY2016). With standard restructured advances and standard advances (undergoing SDR/S4A) aggregating to 5% of the net advances as on March 31, 2017 (8.93% as on March 31, 2016), ICRA expects the asset quality pressures to remain high in FY2018.

Weakening of asset quality has also resulted in profitability pressures on account of elevated credit costs, which stood at 2.47% of ATA during FY2017 as compared with 1.55% in FY2016 and 1.03% in FY2015. However, despite an increase in credit provisions, with the high fresh NPA generation, the bank's NNPAs increased in FY2017 to Rs. 14,118 crore (8.96%) as on March 31, 2017 from Rs. 9,932 crore (6.70%) as on March 31, 2016. With high NNPAs, OBC may be included in the prompt corrective action (PCA) framework of the RBI, which may require it to increase the provision coverage, leading to the credit costs remaining elevated and the pressure on profitability continuing in the near term.

An increase in NPAs has also resulted in a decline in earning assets and consequently a decline in NII during FY2017. The bank's NII declined to Rs. 4,910 crore in FY2017 from Rs. 5,375 crore in FY2016, even as operating expenses continued to increase. Lower NII resulted in lower net interest margins at 2.01% of ATA during FY2017 as against 2.31% in FY2016, whereas the non-interest income including treasury gains subsequent to a decline in yields on government securities increased to 1.13% of ATA in FY2017 as compared with 0.76% of ATA. The increase in treasury profits, however, was only able to partly offset the credit provisions resulting in PAT/ATA of -0.45% during FY2017 as compared with 0.07% during FY2016. With expectations of elevated credit provisions, the bank's net profitability is likely to remain weak in FY2018 as well. Losses during FY2017 led to an erosion of net worth, which coupled with elevated NPAs has also impacted the bank's solvency profile (net NPA/ net worth) which deteriorated to 111.4% as on March 31, 2017 up from 73.93% as on March 31, 2016. The deterioration in OBC's solvency profile reflects its lower ability to withstand unexpected losses. OBC's ability to arrest further deterioration in asset quality and raise capital to create buffers would be critical for its credit profile.

Despite the weakening of its capital ratios, OBC's capitalisation profile remains adequate with an overall CRAR of 11.64% as on March 31, 2017 (11.76% as on March 31, 2016), Tier – I of 8.88% (9.10%) and CET-1 of 7.59% (8.52%) as compared with the regulatory requirement of 10.25%, 8.25% and 6.75% respectively. The capital levels – especially the CET-I level – weakened during the last year in the absence of any equity infusion by the GoI or equity issuances by the bank. The CET-I declined to 7.59% from 8.52% on account of the losses in FY2017 even as the RWA increased by 4.01% following a growth in advances. The bank also raised Tier-I capital of Rs. 1,500 crore during FY2017 through perpetual additional tier I (AT-1) bonds and the cumulative outstanding stood at Rs 2,000 crore (1.1% of RWA) as on March 31, 2017. Following losses in FY2017, the distributable reserves, which can be used to service the coupon on the AT-1 bonds in a year of losses, also reduced to 4.37%[2] of RWAs from 5.57% as on March 31, 2016. Going forward, with increasing capital requirements under Basel III capital regulations, and an assumption of 5-10% growth in RWAs and a 0.5% buffer over the minimum capital requirements, OBC's total equity requirement remains large at Rs 3,000- 4,500 crore during FY2018 and FY2019, which is 60-90% of its current market capitalisation. In case the bank report losses or maintains a higher capital buffer, the capital requirement will increase by a similar amount. In addition to equity, OBC will also be required to raise a minimum of Rs. 500-600 crore of AT-1 bonds during these two years to meet the overall Tier-1 needs. While sovereign ownership is the significant positive factor for the rating, given the bank's large capital requirements in relation to its market capitalisation and the limited cushion to dilute the GoI's stake while maintaining a minimum shareholding of 51%, OBC will be significantly dependent on the GoI to meet its incremental equity capital requirement. As per ICRA's estimates, around 40% of the total equity capital required has to be from the GoI, for it to maintain a minimum 51% shareholding. ICRA expects the GoI to support OBC with the required capital and maintain its majority shareholding in the bank.

OBC's net advances registered a degrowth during FY2017 (-4.1% on y-o-y basis) and stood at Rs 1.41 lakh crore as on December 31, 2016; however, supported by portfolio buyouts from other banks and NBFCs, the advances registered a growth of 5.1% for FY2017, which is higher than PSB average of less than 1%. The loan book growth has been driven by the retail and agricultural segments which reported growths of 37.15% and 11.87% respectively in FY2017, while the MSME segment remained flat. With a higher growth in the retail and agri segments, the share of corporate segment in overall advances declined

[2] As per revised RBI guidelines for Basel III AT-I instruments dated February 2, 2017

to 51.78% as on March 31, 2017 from 53.86% as on March 31, 2016, while the share of retail increased to 15.34% from 12.12%, agriculture increased to 14.50% from 14.04% and MSME declined to 18.38% from 19.98% during the period.

On the deposit side, the bank witnessed a significant improvement in its low cost current account and saving account (CASA) deposits. The CASA deposits increased by 27% in FY2017, which resulted in an increase in the share of CASA in total deposits to 30.5% as on March 31, 2017 from 25.2% as on March 31, 2016. While the share of CASA has gradually been improving over the past two years, the growth was accelerated by the demonetisation of high value currency notes announced by the GoI in Q3FY2017. However despite the improvement, OBC's CASA ratio remains lower than the PSB average of around 35%. This also results in the bank's relatively higher dependence on bulk deposits[3] which accounted for ~28% of total deposits as on March 31, 2017, though lower than the 34% as on March 31, 2016. With declining interest rates and improving CASA, the bank's cost of interest bearing funds improved to 5.70% during Q4FY2017 from 6.8% during Q4FY2016, but remained higher than the PSB average of 5.45%.

OBC's liquidity profile was comfortable without any mismatches in the short term buckets up to 6 months, beyond which, negative mismatches existed in the 6-12 month and 1-3 year buckets as on December 31, 2016. The bank's liquidity is also supported by its sizeable SLR and non-SLR investments at 24% of total assets as on March 31, 2017, which can be used in an event of liquidity requirements.

Analytical approach:
For arriving at the ratings, ICRA has assessed that standalone credit profile of the bank and has also taken into account its majority sovereign ownership.

Links to applicable criteria
[Bank Credit Rating –A Note on Methodology]
[Basel III Compliant Non Equity Rating - A Rating Methodology]

About the bank

Oriental Bank of Commerce (OBC) is owned 58.38% by Government of India (GoI) and operates primarily in northern India. The bank had a network of 2,376 branches as on March 31, 2017. Around 49% of OBC's branches are located in rural and semi urban locations.

OBC reported a loss of Rs. 1,094 crore during FY2017 on an asset base of Rs. 251,583 crore[4] vis-à-vis a net profit of Rs. 156 crore during FY2016 on an asset base of Rs. 236,034 crore. As on March 31, 2017, the bank reported gross NPAs of 13.73% and net NPAs of 8.96%. Its Tier 1 and CRAR stood at 8.88% and 11.64% respectively as on March 31, 2017.

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

[3] Term deposits and Certificate of deposits > 1 crore
[4] Excluding revaluation reserves

Rating history for last three years:

S.No	Instrument	Current Rating (FY2018)			Chronology of Rating History for the past 3 years						
		Type	Rated amount (Rs. crore)	Amount outstanding (Rs. crore)							
					FY2018	FY2017			FY2016		FY2015
					May 2017	Jan 2017	Sep 2016	Jun 2016	Feb 2016	Jan 2015	Mar 2014
1	Basel III compliant Additional Tier I bonds	LT	2,000	2,000	[ICRA] A (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA]A+ (hyb) (Negative)	[ICRA] A+ (hyb) (Stable)	[ICRA] A+ (hyb) (Stable)	[ICRA] AA- (hyb) Stable	
2	Basel III Compliant Tier II Bonds	LT	3,000	3,000	[ICRA] AA- (hyb) (Negative)	[ICRA]AA (hyb) (Negative)	[ICRA]AA (hyb) (Negative)	[ICRA] AA (hyb) (Stable)	[ICRA] AA (hyb) (Stable)	[ICRA] AA+ (hyb) (Stable)	[ICRA] AA+ (hyb) (Stable)
3	Basel II Lower Tier II Bonds	LT	1,200	1,025*	[ICRA] AA- (Negative)	[ICRA]AA (Negative)	[ICRA]AA (Negative)	[ICRA] AA (Stable)	[ICRA] AA (Stable)	[ICRA] AA + (Stable)	[ICRA] AA + (Stable)
4	Basel II Lower Tier II Bonds	LT	500	0	Rating Withdrawn	[ICRA]AA (Negative)	[ICRA]AA (Negative)	[ICRA] AA (Stable)	[ICRA] AA (Stable)	[ICRA] AA + (Stable)	[ICRA] AA + (Stable)
5	Basel II Upper Tier II Bonds	LT	500	500	[ICRA] A+ (Negative)	[ICRA]AA- (Negative)	[ICRA]AA- (Negative)	[ICRA] AA- (Stable)	[ICRA] AA- (Stable)	[ICRA] AA (Stable)	[ICRA] AA (Stable)
6	Basel II Upper Tier II Bonds	LT	500	0	-	Rating Withdrawn	[ICRA]AA- (Negative)	[ICRA] AA- (Stable)	[ICRA] AA- (Stable)	[ICRA] AA (Stable)	[ICRA] AA (Stable)
7	Basel II Perpetual Bonds Programme	LT	250	0	-	Rating Withdrawn	[ICRA]AA- (Negative)	[ICRA] AA- (Stable)	[ICRA] AA- (Stable)	[ICRA] AA (Stable)	[ICRA] AA (Stable)

*Bank only raised Rs. 1,025 crore against rated amount of Rs. 1,200 crore

Annexure-1
Instrument Details

Instrument	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Rated Amount (Rs. crore)	Current Rating and Outlook
Basel III Compliant Additional Tier I Bonds	February10,2015	9.48 %	call option February 10, 2020	500.00	**[ICRA]A (hyb) (Negative)**
	September 16,2016	10.95%	call option September 16,2021	1000.00	
	September 30,2016	10.95%	call option September 30,2021	500.00	
Basel III Compliant Tier II Bonds	October 27,2014	9.20 %	October 27, 2024	1000.00	**[ICRA]AA- (hyb) (Negative)**
	October 26,2015	8.34%	October 26, 2025	1000.00	
	June 24,2016	9.05%	June 24,2026 call option June 24,2021	1000.00	
Basel II Lower Tier II Bonds	November 30,2012	8.93%	November 30, 2022	1025.00	**[ICRA]AA- (Negative)**
	N A	N.A.	N.A.	175.00 (not issued)	
Basel II Upper Tier II Bonds	February 12,2009	8.75% (Step-up)	February 12, 2024 call option February 12, 2019	500.00	**[ICRA]A+ (Negative)**

Source: Oriental Bank of Commerce

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