

June 20, 2017

## UCO Bank

### Summary of rated instruments

Instrument*	Rated Amount (Rs. crore)	Rating Action
Lower Tier II Bonds – Basel II	800.00	[ICRA]A+ (Negative); Downgraded from [ICRA]AA- (Negative)
Upper Tier II Bonds – Basel II	500.00	[ICRA]A- (Negative); Downgraded from [ICRA]A (Negative)

\*Instrument details are provided in Annexure-1

### Rating action

ICRA has downgraded the rating on the Rs. 800 crore Lower Tier II bonds programme of UCO Bank (UCO) from [ICRA]AA- (pronounced ICRA double A minus) to [ICRA]A+ (pronounced ICRA A plus). ICRA has also downgraded the rating on the bank's Rs. 500 crore Upper Tier II Bond programme from [ICRA]A (pronounced ICRA A) to [ICRA]A- (pronounced ICRA A minus). The outlook on the long term ratings of the bank is 'Negative'.

### Rationale

The ratings downgrade takes into account UCO's weak operating and financial performance during Q4FY2017 and in FY2017 overall, as reflected by the continued losses during the last two fiscal years driven by high levels of non-performing assets (NPA). The high levels of losses have resulted in weak capitalisation levels and solvency profile for the bank. The ratings downgrade and negative outlook are driven by ICRA's unfavourable outlook on the bank's profitability amid high levels of NPAs and the consequent challenges which the bank is likely to face to meet the increasing capital requirements under Basel III regulations.

The bank's asset quality remains weak with gross and net NPAs of 17.13% and 8.94% respectively as on March 31, 2017 as compared with 15.44% and 9.09% respectively as on March 31, 2016. ICRA also notes that with the standstill clause being applicable on asset classification under various schemes on resolution of stressed assets, UCO has a large number of loans continuing to be classified as standard accounts; the reported asset quality is hence, likely to deteriorate further going forward. The rise in NPAs and the consequent income reversals led to a decline in the bank's net interest income (NII) by 21.27% in FY2017. The bank's operating expenses also increased by 5.78% during the year. UCO's core operating profits<sup>1</sup> consequently declined by 41.8% to Rs. 1,685 crore, which were not adequate to absorb the high credit provisions during the year, resulting in a net loss of Rs. 1,850.7 crore during FY2017.

Despite an equity raising of Rs 2,183 crore (including Rs. 1,925 crore from the Government of India (GoI)) and raising of Additional Tier 1 (AT 1) bonds of Rs. 750 crore during FY2017, the bank's capital ratios remain weak with limited cushion to absorb future losses. While the Tier 1 capital improved to 8.27% as on March 31, 2017 from 7.75% as on March 31, 2016, it is only marginally higher than the regulatory minimum of 8.25% (including capital conservation buffer of 1.25%) as of March 31, 2017 mainly on account of the sustained losses. Further, the bank's capital requirement remains large in relation to the Basel III requirements with limited cushion available to absorb losses.

<sup>1</sup> Operating profits before credit provisions and profits from treasury activities

In May 2017, the Reserve Bank of India (RBI) included UCO under the prompt corrective action (PCA) framework given the bank's high net NPAs and negative return on assets. Inclusion under PCA would entail that the bank raises more capital and create higher provisions for NPAs. With 5-10% growth in risk weighted assets (RWA) and a 50 bps cushion on the minimum regulatory capital requirements, ICRA expects the bank to require a total Tier 1 capital of Rs. 3,000-Rs. 4,300 crore during FY2018 and FY2019, of which Rs. 1,800-3,000 crore has to be equity capital to meet CET-I requirements and balance AT-1 bonds. With consecutive net losses during the last two years, UCO's distributable reserves have been eroded significantly, thereby constraining the bank's ability to raise AT-1 capital. ICRA expects the overall equity requirement may increase to meet the Tier 1 capital requirement. UCO's fresh Tier 1 capital raising requirements are large in relation to its market capitalisation at ~55-80%. These capital estimates will also increase to the extent of the losses reported by the bank during the projected period.

The ratings continue to draw comfort from UCO's majority sovereign ownership (76.67% shareholding by the GoI as on March 31, 2017<sup>2</sup>), and the bank's strong franchise which translates into a healthy and stable deposits base.

### **Key rating drivers**

#### **Credit strengths**

- Majority GoI ownership and demonstrated support by way of capital infusion

#### **Credit weaknesses**

- Weak asset quality with high gross and net NPAs; asset quality expected to remain weak given the high stock of vulnerable assets
- Earnings profile expected to remain weak with core operating profits expected to be inadequate to cover credit provisions in near term
- Large capital requirements under Basel III regulations, with Tier 1 requirement at 55-80% of current market capitalisation over the next two years
- Low capital cushion to absorb losses with Tier 1 and CRAR at 8.27% as against the regulatory minimum of 8.25% as on March 31, 2017

### **Description of key rating drivers**

Despite a higher level of upgrades and cash recoveries of Rs. 4,300 crore and Rs. 2,039 crore in FY2017 as compared with Rs. 1,358 crore and Rs. 1,369 crore respectively in FY2016, the bank's gross NPAs increased by 7.8% to Rs. 22,541 crore as on March 31, 2017. Its gross NPA ratio of 17.13% as on March 31, 2017 is considerably higher than the PSB average of 11.4%. The deterioration in gross NPAs was mainly on account of the high slippages of Rs. 9,909 crore (8.28% of net advances) in FY2017. The increase was despite UCO selling 14 accounts aggregating to Rs. 1,123.41 crore to asset reconstruction companies in FY2017 as compared with 10 accounts of Rs. 542.52 crore during FY2016. With standard accounts under standstill clause under various schemes for resolution of stressed assets estimated at 5.3% of net advances as on March 31, 2017, ICRA expects fresh slippages to continue during FY2018 unless a resolution is achieved on these accounts. UCO's provision coverage ratio at 53% (61% including technical write-offs) was higher than the PSB average of 44% (58% including technical write-offs) as on March 31, 2017. The bank's net NPAs reduced marginally to 8.94% as on March 31, 2017 from 9.09% as on March 31, 2016. Rising asset quality stress also resulted in a weak solvency profile as reflected by net NPAs/net worth of 102.64% as on March 31, 2017 as compared with 112.67% as on March 31, 2016.

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<sup>2</sup> GoI shareholding is expected to increase to 80.5% upon allotment of shares against the share application money of Rs. 1,150 crore infused in March 2017.

With high NPAs and the consequent decline in earning assets, the bank's net interest income (NII) declined by 21.27% in FY2017. Its net interest margins (NIM) consequently, declined to 1.62% of ATA<sup>3</sup> in FY2017 from 1.99% of ATA in FY2016. The operating expenses however increased to 1.27% of ATA during FY2017 from 1.16% during FY2016, resulting in a decline in core operating profitability<sup>4</sup> to 0.71% during FY2017 from 1.19% during FY2016. Supported by treasury gains of Rs. 1,240.8 crore (0.53% of ATA) during FY2017, the bank was partially able to offset the elevated credit costs of 1.87% of ATA during FY2017 (2.58% in FY2016). It reported an overall net loss of 0.78% of ATA in FY2017 in comparison with 1.15% of ATA in FY2016. Given the two consecutive years of losses and the high net NPA levels, the RBI invoked PCA in the bank, which is likely to lead to mandatory and discretionary corrective actions under the framework.

Despite a capital infusion of Rs. 2,183 crore (including Rs. 1,925 crore by the GoI), during FY2017, the bank's Tier 1 capital stood at 8.27%, only marginally higher than the regulatory requirement of 8.25% as on March 31, 2017. It will be critical for the bank to raise fresh capital to meet the regulatory capital requirements under Basel III; the bank plans to raise Rs. 2,000-2,500 crore of equity capital in FY2018. Given the GoI shareholding at ~80.5% (including share application money pending allotment), the bank has considerable scope to raise capital from non-government sources while maintaining the GoI shareholding above 51% levels. As per ICRA's estimates, assuming a 5-10% growth in RWA, and 50 bps cushion on the minimum Basel III capital requirements, the bank will require Tier 1 capital of Rs. 3,000-Rs. 4,300 crore during FY2018 to FY2019. Of this, Rs 1,800-3,000 crore is likely to be in the form of equity capital to meet CET-I requirements and balance through AT-1 bonds. The consecutive losses in FY2016 and FY2017 have also weakened the bank's ability to raise capital through AT1 issuances with distributable reserves<sup>5</sup>/RWA of ~1.25% as on March 31, 2017, which is much lower than PSB average. Hence, the overall Tier I capital requirements may need to be met through equity sources. The total Tier 1 capital required is ~55%-80% of the current market capitalisation of the bank. The capital requirement will be higher to the extent of losses incurred by the bank during FY2018 and FY2019.

UCO's loan book declined by 4.91% during FY2017 to Rs. 1.19 lakh crore as on March 31, 2017. The decline in the loan book was largely in the Industry segment (-6.26%) and Others (-23.12%), albeit a healthy growth in the Personal Loans (+26.08%), Services (+13.81%) and Agriculture segments (+2.55%) during FY2017. The Industry segment continues to account for the major share of the portfolio at 49.87% as on March 31, 2017 followed by Agriculture (15.26%), Services (12.87%), Personal Loans (10.01%) and Others (11.99%). Given the asset quality issues in the Industry segment, the bank has shifted to the Personal Loans segment whose share of total loans increased to 10.01% as on March 31, 2017 from 7.71% as on March 31, 2016 while that of Industry segment declined to 49.87% from 51.69%. The decline in net loans resulted in a drop in the bank's risk weighted assets by 8.17% during FY2017 which in turn supported its capital ratios.

On the deposit front, the bank's domestic low cost current account and saving account (CASA) deposit ratio increased to 33.92% as on March 31, 2017 (31.68% as on March 31, 2016) mainly driven by demonetisation. However, the CASA ratio is lower than the PSB average of 36.7% as on March 31, 2017. With declining interest rates and the slight improvement in CASA base, the bank's cost of interest bearing funds declined to 5.61% during Q4FY2017 from 6.32% during Q4FY2016; it however remained higher than the PSB average of 5.45% during Q4FY2017.

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<sup>3</sup> Average total assets

<sup>4</sup> Core operating profitability excluding gain on sale of investments and credit provisions

<sup>5</sup> Calculated as per revised the RBI guidelines notified on February 2, 2017 for FY2017.

**Analytical approach:**

The ratings for UCO derive significant support from its GoI parentage and any change in the support provided by the GoI could warrant a rating change for the bank.

**Links to applicable criteria**

[ICRA Rating Methodology for Banks](#)

**About the bank:**

UCO Bank was established in 1943 as United Commercial Bank and was nationalised in 1969. The bank was wholly owned by the Government of India until September 2003, when an initial public offer resulted in the stake reducing to 75%. As on March 31, 2017, the GoI held 76.67% stake in the bank. As on March 31, 2017, the bank operated 3,104 branches, out of which two branches are in Hong Kong and two are in Singapore. The bank is focussed on rural and semi-urban segments, with around 61% of the bank's branches being in these areas. The bank operated 2,779 ATMs as on March 31, 2017.

For FY2017, the bank reported a net loss of Rs. 1,851 crore on an asset base of Rs. 2,29,015 crore as compared with a net loss of Rs. 2,799 crore on an asset base of Rs. 2,42,517 crore for FY2016. As on March 31, 2016, the bank's capital adequacy was 10.93% (Tier-1: 8.27%; both Basel III), while its gross and net NPAs stood at 17.13% and 8.94%.

**Status of non-cooperation with previous CRA:** Not Applicable

**Any other information:** Not Applicable

**Rating history for last three years:**
**Table:**

Sl. No.	Instrument	Current Rating (FY2018)			Chronology of Rating History for the past 3 years					
		Type	Rated Amount (Rs. crore)	FY 2018	FY 2017				FY 2016	FY 2015
					June 2017	June 2016	May 2016	April 2016	Feb 2016	January 2015
1	Lower Tier II Bonds	Long Term	800.00	[ICRA]A+ (Negative)	[ICRA]AA- (Negative)	[ICRA]AA- (Negative)	[ICRA]AA (Negative)	[ICRA]AA (Negative)	[ICRA]AA (Stable)	
2	Lower Tier II Bonds	Long Term	275.00	-	-	-	Withdrawn	[ICRA]AA (Negative)	[ICRA]AA (Stable)	
3	Upper Tier II Bonds	Long Term	500.00	[ICRA]A- (Negative)	[ICRA]A (Negative)	[ICRA]A+ (Negative)	[ICRA]AA- (Negative)	[ICRA]AA- (Negative)	[ICRA]AA- (Stable)	

**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](http://www.icra.in)

**Annexure-1**  
**Instrument Details**

<b>Instrument</b>	<b>Date of Issuance / Sanction</b>	<b>Coupon Rate</b>	<b>Maturity Date</b>	<b>Rated Amount (Rs. crore)</b>	<b>Current Rating and Outlook</b>
Lower Tier II Bonds	08-Mar-2010	8.92%	08-Mar-2020	800.00	[ICRA]A+ (Negative)
Upper Tier II Bonds	25-Mar-2010	8.90%	25-Mar-2025 (Call: 25-Mar-2020)	500.00	[ICRA]A- (Negative)

Source: UCO Bank

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