PNB Gilts Limited

September 21, 2018

Summary of rated instruments

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Commercial Paper Programme	500.00	500.00	[ICRA]A1+; Reaffirmed
Total	**500.00**	**500.00**	

**Instrument details are provided in Annexure-1*

Rating action

ICRA has reaffirmed the short-term rating of [ICRA]A1+ (pronounced ICRA A one plus) for the Rs. 500-crore[1] commercial paper programme of PNB Gilts Limited (PNB Gilts)[2].

Rationale

The assigned rating factors in PNB Gilts' strong capital profile, sizeable net worth and comfortable liquidity. The liquidity is supported by a highly liquid portfolio of Government securities (G-Secs) and access to call money and repo borrowings, in addition to access to liquidity adjustment facility (LAF) support from the Reserve Bank of India (RBI) that is available to primary dealers (PDs). Further, the company has adequate internal prudential norms and risk management policies that mitigate the market risks arising out of interest rate movements, which are intrinsic to the business of a PD. The rating factors in PNB Gilts' ownership with Punjab National Bank (PNB, rated [ICRA]AA-(Negative)/[ICRA]A1+) as its largest shareholder, and the managerial, operational and financial support received from PNB.

ICRA takes note of the relatively less diversified revenue stream of PNB Gilts vis-à-vis other PDs, which thus increases its reliance on interest income and trading income. ICRA further notes the fact that the company's overall profitability and capitalisation is subject to volatility because of interest rates. With the hardening of interest rates during FY2018 and the elevated level of yields during H1 FY2019 resulting in a decline in trading profits, the company's profitability remained muted with a return on net worth of 4.15% during FY2018 and -5.44% during Q1 FY2019. Profitability is expected to remain weak during FY2019 as well. However, a strong capital profile with sizeable net worth provides the company with comfortable cushion to withstand large adverse movements in interest rates, while continuing to maintain regulatory capital adequacy. Going forward, PNB Gilts' ability to withstand any volatility in interest rates while maintaining prudent risk management policies, continuity of management control by PNB, and impact of regulatory changes for PDs will remain key rating sensitivities.

Key rating drivers

Credit strengths

Strong capital profile – PNB Gilts' capital adequacy remained strong with its capital to risk weighted assets ratio (CRAR) at 47.64% as on June 30, 2018, well above the regulatory minimum of 15% for PDs. Although the CRAR declined from 67.09% as on March 31, 2018 because of a loss in Q1 FY2019, it has remained comfortable. With interest rate volatility driving the company's trading income as well as its net interest income (NII) and hence its profitability, a sizeable net

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[1] *100 lakh = 1 crore = 10 million*

[2] *For complete rating scale and definitions, please refer to ICRA's website www.icra.in or other ICRA Rating Publications*

worth provides PNB Gilts with comfortable cushion to absorb any losses. As on June 30, 2018, PNB Gilts had a net worth of Rs. 813.03 crore (with Net Owned Fund (NOF) of Rs. 799.65 crore), and a price value of basis point (PVBP)[3] of Rs. 0.68 crore, indicating the ability to absorb large adverse movements of 1,176 basis points (bps) in interest rates.

Comfortable liquidity with large portfolio of G-Secs - The company has a large portfolio of highly liquid Government securities (G-Secs, SDL and GoI T-bills). As on June 30, 2018, the company's investment in G-Secs accounted for 78% (Rs. 4,724 crore) of its total assets against 74% (Rs. 3,991 crore) as on March 31, 2018. On a daily average basis, the G-Secs accounted for 74% of its average total assets during FY2018. Additionally, on a daily average basis, 15% and 8% of the company's average total assets were in highly rated corporate bonds (rated AAA/AA+) and liquid mutual funds, respectively, during FY2018. With the funds parked in highly liquid investments, PNB Gilts' overall liquidity remains strong. The liquidity is also supported by the company's access to the money market for call and repo borrowings, in addition to the RBI's LAF. Moreover, PNB Gilts has sanctioned bank limits of Rs. 1,500 crore from PNB. Though the company's liabilities are largely short term in nature compared to the long tenure of its assets, the liquid nature of the assets mitigates the asset-liability risks. PNB Gilts continues to fulfil its regulatory bidding commitments at the primary auctions with minimum success and turnover ratio requirements for dated Government securities and Treasury bills (T-bills).

Adequate risk management systems – Being a PD, PNB Gilts faces significant risks because of adverse interest rate movements as well as exposure to credit risks in non-SLR debt instruments. In this regard, prudent risk management policies and adherence to the same is critical for a PD. ICRA takes comfort from the strong risk management policies approved by the company's board with well-defined norms for investments, leverage, portfolio mix, funding, PVBP and stop-loss limits apart from proper monitoring and adherence to these policies. The company uses Value-at-Risk (VaR) and stress testing tools to monitor and measure the impact of interest rate movements on its portfolio to assess the market risk and ensure that it is within the allowed limits approved by the board. The approved VaR is less than 10% of the net worth and during FY2018 and Q1 FY2019, the actual VaR remained within the approved limits. As per the risk management policy, investment in non-SLR securities is allowed only for AAA, AA+ and A1+ rated entities, which mitigates any credit risk, though liquidity risk may still remain.

Credit challenges

Low diversity in revenue streams – PNB Gilts' revenue stream is relatively less diversified than that of some other PDs, with interest income and trading income accounting for almost ~99.6% of the company's total revenue. Consequently, profitability is greatly impacted by adverse interest rate movements.

Profitability to remain weak given the hardening of bond yields – PNB Gilts' total portfolio largely consists of debt securities, resulting in its profitability profile being highly dependent on adverse interest rate movements. This is reflected in the sizeable decline in trading profits during FY2018 (Rs. 7.23 crore; because of a sizeable rise in bond yields) against trading profits of Rs. 185.5 crore (after a decline in bond yields) during FY2017. The trading losses during FY2018 could have been higher if the mark-to-market (MTM) losses (Rs. 38.62 crore as on March 31, 2018 against Rs. 4.53 crore as on March 31, 2017) on the held-to-maturity (HTM) book would have been fully provided for during FY2018. With a significant decline in trading profits and a marginal decline in net interest income because of a rise in interest rates, PNB Gilts reported a net profit of Rs. 36.58 crore during FY2018 (return on net worth - RoNW of 4.15%) against a net profit of Rs. 167.17 crore (RoNW of 18.60%) during FY2017. Upon transition to new accounting standards (IND-AS), the MTM losses on the HTM book were fully provided for during Q1 FY2019, which resulted in a net loss of Rs. 44.25 crore (RoNW of -5.44%). With interest rates likely to remain firm in FY2019, the likelihood of trading gains appears to be limited and

[3] *PVBP measures the gain/loss on the entire portfolio for 1 basis point (0.01%) movement in interest rate*

ability to absorb operating costs and offset trading losses through NII will be the key driver of net profitability. Further, the NII will remain susceptible to a rise in short-term interest rates, which have hardened during H1 FY2019 upon two consecutive hikes in repo rates by the RBI. Overall, the outlook on profitability remains challenging for FY2019.

Regulatory framework for PDs – The RBI is the regulatory authority for PDs and has prescribed operational guidelines about underwriting commitments for G-Secs and T-bills, achieving minimum turnover ratios and funding support from the RBI in the form of LAF. Any significant change in the regulatory framework for PDs, adversely impacting the company's operational and financial profile, would be a key rating sensitivity.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below.

Links to applicable criteria:

Rating Methodology for Primary Dealers

About the company

PNB Gilts Limited is a leading primary dealer in the Government securities market. Incorporated in 1996 as a wholly-owned subsidiary of Punjab National Bank, with an initial paid-up capital of Rs. 50 crore, the company undertakes most of its operations in G-Secs. The range of products and services offered by the company includes T-bills, Central Government dated securities, state government securities, public sector undertaking bonds, inter-corporate deposits, money market instruments, mutual fund distribution and investment/trading in equity and equity derivatives. In addition, the company offers advisory services to clients to manage the G-Secs portfolio. In July 2000, the company came out with an IPO, thereby reducing the holding of Punjab National Bank to 74.07%.

In FY2018, the company reported a profit after tax (PAT) of Rs. 36.58 crore on a total income of Rs. 409.94 crore compared to PAT of Rs. 167.17 crore on a total income of Rs. 500.67 crore in FY2017. PNB Gilts achieved a success ratio[4] of 42.48% in the T-bills market in H1 FY2018 and 40.91% in H2 FY2018, above the regulatory requirement of 40%. During FY2018, PNB Gilts had a turnover ratio[5] of 284 times (511 in FY2017) for dated G-Secs and 83 times (104 in FY2017) for T-bills.

[4] *Success ratio is defined as Bids accepted / Bidding commitment*
[5] *Turnover ratio is the ratio of total purchase and sales during the year in the secondary market to average month-end stocks*

Key financial indicators (Q1 FY2019 results are unaudited)

	FY2017	FY2018	Q1 FY2018	Q1 FY2019
Net Interest Income (NII)	88.03	70.12	11.20	19.88
Trading Profits	185.50	7.23	33.86	-25.56
Underwriting & Other Income	1.30	1.86	1.68	0.91
Operating Costs	18.29	23.93	6.67	4.75
Profit before Tax	256.54	55.28	38.53	-43.31
Profit after Tax (PAT)	167.17	36.58	25.11	-44.25
Net Worth	898.36	880.66	881.27	813.03
Borrowings	3,513.93	4,368.65	6,519.84	5,902.30
Stock-in-Trade	3,885.35	4,200.35	6,730.81	6,413.65
Total Assets	4,565.51	5,385.81	7,389.64	6,715.33
PAT/ATA	3.24%	0.74%	0.84%	-0.73%
PAT/Net Worth (RoNW)	18.60%	4.15%	2.85%	-5.44%
Total debt / net worth (times)	3.91	4.96	7.50	6.91

Amounts in Rs. crore; Figures as per ICRA research

Source: PNB Gilts Limited, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

	Current Rating (FY2019)				Chronology of Rating History for the Past 3 Years			
				Date & Rating	Date & Rating in FY2018		Date & Rating in FY2017	Date & Rating in FY2016
Instrument	Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	September 2018	February 2018	August 2017	-	-
Commercial Paper	Short Term	500.00	-	[ICRA]A1+; Reaffirmed	[ICRA]A1+;	[ICRA]A1+ Assigned	-	-

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 No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Commercial Paper	NA	NA	7-365 days	500.00	[ICRA]A1+

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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