August 29, 2019

UCO Bank: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount(Rs. crore)	Rating Action
Lower Tier II Bonds – Basel II	800.00	800.00	[ICRA]A+(Negative); reaffirmed
Upper Tier II Bonds – Basel II	500.00	500.00	[ICRA]A- reaffirmed; removed from 'rating watch with developing implications' and 'negative' outlook assigned
Total	**1,300.00**	**1,300.00**	

**Instrument details are provided in Annexure-1*

Rationale

The rating reaffirmation and removal of the 'rating watch with developing implications' on the Basel II compliant Upper Tier II bonds factor in the large capital infusion of Rs. 6,406 crore (~6.54% of Tier I) by the Government of India (GoI) in FY2019. This resulted in the bank reporting capital ratios above the minimum regulatory levels[1] for the last three consecutive quarters, enabling it to service its debt capital instruments.

The Negative outlook on the ratings continues to be driven by the likely pressure on the asset quality and consequent pressure on profitability and the capitalisation profile in FY2020. The asset quality issue is expected to be affected by the expectation of fresh slippages of ~5.0-6.0% of standard assets in FY2020 and the high stock of unprovided stressed assets. ICRA expects credit provisions of ~4.5-5.3% of net advances in FY2020, which will exceed the bank's core operating profits and hence translate into fresh capital requirements for maintaining the capital ratios.

As per ICRA's estimates, UCO will require capital infusion of ~Rs. 3,600-4,970 crore (~31-43% of its market capitalisation), assuming a 5-7% growth in the risk weighted assets (RWAs), in FY2020 to report a minimum Tier I capital ratio of 9.5% (including CCB of 2.5%) and cushion of 50 bps. Given its weak earnings profile, the bank will remain highly dependent on the GoI for capital infusion. As per ICRA's estimates, even if the bank were not to maintain the CCB, it will require capital infusion to achieve a CRAR of 9% by March 2020, thereby driving the Negative outlook on the ratings.

However, the ratings continue to factor in the GoI's majority sovereign ownership in the bank at 92.52% as on June 30, 2019 and its demonstrated support for capital infusion, as well as the bank's strong deposit franchise, which translates into a healthy and stable deposit base. The GoI has already announced a capital infusion of Rs. 70,000 crore into public sector banks (PSBs) for FY2020, and ICRA expects UCO to receive enough capital to meet the CRAR requirement of 9% for servicing its bonds.

UCO is currently under the prompt corrective action (PCA) framework of the Reserve Bank of India (RBI) and its ability to exit the same will be driven by a reduction in the net NPA (NNPA) ratio to less than 6.0% (NNPA of 8.98% as on June 30, 2019) and the maintenance of the CCBs. This, in turn, will depend on the extent of capital infusion by the GoI. The ratings

[1] *Tier I of 7% or CRAR of 9%, excluding required CCB of 2.5% as on March 31, 2020*

are further constrained by the weak profitability profile marked by four consecutive years of losses (FY2016-FY2019), with the same expected to continue in FY2020.

Outlook: Negative

ICRA expects the bank's operating profits to remain insufficient to absorb the high credit provisions, resulting in net losses in FY2020 and large capital requirements. The extent of recovery from the resolution of accounts under the National Company Law Tribunal (NCLT) will continue to drive the level of losses and capital required for FY2020. The ratings may be downgraded if the bank reports a CRAR below 9% and the capital infusion does not materialise in a timely manner as this will impact its ability to service its debt capital instruments.

Key rating drivers

Credit strengths

Majority sovereign ownership – The GoI held 92.52% equity in the bank as on June 30, 2019. The GoI, which has demonstrated consistent capital support to UCO, infused Rs. 6,507 crore and Rs. 6,406 crore of equity capital in FY2018 and FY2019, respectively. A high GoI shareholding provides the bank with the ability to raise capital from market sources while maintaining a majority GoI shareholding. However, given its weak operating and financial profile, the bank's ability to raise capital from the market remains to be seen. In the absence of the same, the bank will remain significantly dependent on the GoI to meet the regulatory capital ratios. ICRA expects that the GoI will provide capital to PSBs, including UCO, to meet the regulatory capital ratios and this will be critical from a near-term rating perspective.

Stable deposit base driven by strong franchise – UCO reported a YoY rise of 7.9% in its total deposits though the same declined by 2.8% QoQ to Rs. 1,92,364 crore as on June 30, 2019. The healthy deposit base was mainly driven by the bank's strong franchise of 3,088 branches, including one in Hong Kong and one in Singapore as on June 30, 2019. It is mainly focussed on the rural and semi-urban segments, with around 61% of its branches being in these areas. The deposit base was also supported by UCO being a designated bank for settling payments for India's oil imports from Iran, resulting in an accretion in interest-free demand deposits in FY2019. This also benefited UCO by way of a 34% YoY increase in low-cost current account and savings account (CASA) deposits as on March 31, 2019 and a 26% YoY increase as on June 30, 2019, thereby resulting in lower costs of funds and improved profitability. However, this arrangement ended in Q1 FY2020, leading to a sequential decline in demand deposits. Hence, these deposits will require to be replaced by interest-bearing deposits. The benefit of the Iran deposits is expected to end gradually by Q3 FY2020 and is likely to increase the cost of funds. Because of the above arrangement, the CASA deposits improved to 41.4% of the total deposits as on June 30, 2019 from 35.5% as on June 30, 2018. Excluding the deposits under the Iran arrangement, the bank's CASA increased by 9.1% on a YoY basis as on June 30, 2019, reflecting stability in the core depositor base.

Credit challenges

Capital ratios remain weak with large capital requirement and high GoI dependence in FY2020 – UCO reported Tier I and CRAR of 8.64% and 10.70%, respectively, as on March 31, 2019, which was lower than the minimum regulatory levels (including CCB of 1.875%) of 8.875% and 10.875%, respectively, as on March 31, 2019. Despite sizeable losses, the bank's capital ratio was supported by a capital infusion by the GoI as well as a reduction in RWAs by 7% in FY2019. The capital ratios were weak despite the GoI's high capital infusion of Rs. 6,406 crore (6.54% of Tier I) in FY2019. Earlier, the bank received capital infusions from the GoI of Rs. 6,507 crore in FY2018, Rs. 1,925 crore in FY2017 and Rs. 935 crore in

FY2016. The weak capital ratios were mainly due to the high losses with a loss before tax of Rs. 4,306 crore and Rs. 4,427 crore in FY2019 and FY2018, respectively.

Further, the bank reported Tier I and CRAR of 8.32% and 10.88%, respectively, as on June 30, 2019, which were lower than the minimum regulatory Tier I and CRAR (including CCB of 2.50%) levels of 9.50% and 11.50%, respectively, as on March 31, 2020. ICRA notes that with losses expected in FY2020, the bank will need to raise capital immediately to maintain the capital ratios above the regulatory requirement.

ICRA expects that the bank will require a large capital infusion of ~Rs. 3,600-4,970 crore (~31-43% of its market capitalisation), assuming a 5-7% growth in RWAs, in FY2020 to report a minimum Tier I capital ratio of 9.5% including CCB of 2.5% and cushion of 50 bps. If the bank does not maintain the CCB, the capital requirement will be lower at ~Rs. 1,030-2,350 crore (~9-20% of its market capitalisation) with 50 bps cushion over the regulatory level. ICRA will continue to monitor UCO's capital raising in FY2020 and timely capital support from the GoI will be a key rating sensitivity for the Upper Tier II bonds.

Earlier in FY2019, the bank had intermittently breached the regulatory capital ratios, which are critical for servicing its debt capital instruments. UCO reported Tier I and CRAR of 5.57% and 7.57%, respectively, as on September 30, 2018 and breached the minimum regulatory Tier I and CRAR (excluding CCB) of 7.0% and 9.0%, respectively, which are mandatory to service the coupon payments on the Basel II debt capital instruments. However, the bank was subsequently able to report Tier I and CRAR ratios above 7.0% and 9.0%, respectively, from the last three consecutive quarters mainly supported by high capital infusion from the GoI. Given the GoI's public sector bank recapitalisation plan of Rs. 70,000 crore for FY2020, ICRA expects UCO to maintain its capital ratios above the regulatory levels.

Asset quality to remain weak in FY2020 with expectations of high slippages – UCO's asset quality remained elevated with gross NPAs (GNPAs) of 24.86% at the end of Q1 FY2020 (25.72% at the end of Q1 FY2019 and 25.0% at the end of Q4 FY2019), above the PSBs' average. The marginal decline in the GNPA ratio on a sequential basis was due to a fall in the absolute level of GNPAs to Rs. 29,432 crore as on June 30, 2019 from Rs. 29,888 crore as on March 31, 2019, coupled with a QoQ decline of 1% in gross advances as on June 30, 2019. The decline in GNPAs was mainly due to the sizeable write-offs of Rs. 4,421 crore in FY2019 and Rs. 866 crore in Q1 FY2019, even as slippages remained high at Rs. 1,233 crore or a fresh slippage rate of 5.50% in Q1 FY2020 (Rs. 1,633 crore or 7.92% in Q4 FY2019).

The bank continued to report high slippages of Rs. 9,082 crore (fresh slippage rate of 9.73%) in FY2019 and Rs. 15,034 crore (13.79%) in FY2018. Write-offs have been increasing consistently for the bank at Rs. 4,420 crore or 14.5% of opening GNPAs in FY2019 from Rs. 2,735 crore or 12.1% of opening GNPAs in FY2018. Excluding write-offs, the absolute level of GNPAs would have increased by 3.1% YoY to Rs. 34,309 crore or a GNPA ratio of 28.7% as on March 31, 2019 compared to 26.9% as on March 31, 2018. In FY2019, the sale of NPAs to asset reconstruction companies (ARCs) remained minimal compared with 20 accounts of Rs. 1,764.39 crore in FY2018. The decline in the absolute level of the GNPAs was also due to a higher recovery of Rs. 2,992 crore in FY2019 compared to Rs. 1,680 crore in FY2018. UCO reported upgrades of Rs. 2,332 crore in FY2019 compared to Rs. 2,610 crore in FY2018. As a result, the recovery and upgrades, as a percentage of opening GNPAs, stood at 17.4% in FY2019 compared to 19.0% in FY2018. However, the bank's recovery and upgrades, as a percentage of opening GNPAs, were higher than the PSBs' average of ~13.9% and ~16.5% in FY2018 and FY2019, respectively, mainly because the bank's NPA accounting is done on a gross basis.

The bank's provision coverage ratio increased to 70.16% (77.12% including technical write-offs or TWO) as on June 30, 2019 from 67.71% (74.93% including TWO) as on March 31, 2019. However, the provision coverage ratio (including TWO) was largely in line with the PSBs' average of ~74.8% as on March 31, 2019. As a result, the NNPAs declined to 8.98% as on June 30, 2019 (9.72% as on March 31, 2019). Further, the elevated asset quality stress resulted in a weak solvency profile, as reflected by NNPAs/CET I of 107% at the end of Q1 FY2020 (114% at the end of Q4 FY2019), weaker than the PSBs' average. Because of the elevated NPA levels, the bank remains under the PCA framework and its exit is likely to be driven by the extent of capital infusion by the GoI into the bank. Due to UCO's high NNPAs and negative return on assets, the RBI included it in threshold 1 of the PCA framework in May 2017. ICRA expects the bank to report a high slippage rate of ~5.0-6.0% in FY2020 (5.5% in Q1 FY2020; 9.7% in FY2019), which is likely to translate into a GNPA ratio of ~23.1-24.0% as on March 31, 2020. However, with an expected higher provision coverage ratio of ~83-85%, the NNPA ratio is expected to be lower than 6% as on March 31, 2020. Such a provisioning is expected to result in a breach of the capital ratios for the bank. Hence, despite the reduction in NNPAs to below 6%, the ability to exit the PCA framework will be driven by capital infusion and consequent capital ratios of the bank.

Weak earnings profile marked by four consecutive years of losses, with the same expected to continue in FY2020 mainly due to weak asset quality – UCO's net interest income (NII) increased by 8.7% YoY and 3.3% QoQ to Rs. 1,335 crore in Q1 FY2020. The yield on advances increased to 8.1% in Q1 FY2020 (8.1% in Q1 FY2019 and 7.8% in Q4 FY2019), whereas the cost of average interest-bearing funds declined to 4.9% in Q1 FY2020 (5.3% in Q1 FY2019 and 5.1% in Q4 FY2019). The yield on advances improved mainly due to lower interest reversal while the cost of average interest-bearing funds improved mainly due to the high level of demand deposits related to Iran. The bank's net interest margins (NIMs) remained at ~2.4% in Q1 FY2020, at similar levels on a YoY and QoQ basis. The yield on assets remained below the PSBs' average because of the low credit-to-deposit ratio, given the capital constraints for the bank and the high level of NPAs resulting in a high level of non-interest earning assets.

Further, UCO's core operating profit (excluding credit provisions and profits from treasury activities) deteriorated to 1.6% of ATA (Q1 FY2020) from 2.2% of ATA (Q1 FY2019) though it improved from 1.2% (Q4 FY2019). The YoY decline in the operating profit was due to a recovery in an NPA account in the year-ago period (Q1 FY2019), which was accounted for in interest income. On an adjusted basis, the bank's operating profitability improved in Q1 FY2020 compared to Q1 FY2019.

The operating profit remained insufficient to absorb the high credit provisions (5.6% of advances in Q1 FY2020 compared to 7.9% in Q1 FY2019 and 10.8% in Q4 FY2019), resulting in a loss before tax of Rs. 601 crore in Q1 FY2020 compared to a loss before tax of Rs. 599 crore and Rs. 1,552 crore in Q1 FY2019 and Q4 FY2019, respectively. UCO continued to report losses over the last four consecutive fiscal years with a loss before tax of Rs. 4,306 crore in FY2019, Rs. 4,427 crore in FY2018, Rs. 1,840 crore in FY2017 and Rs. 2,779 crore in FY2016, primarily due to elevated provisioning on account of the weak asset quality.

ICRA expects that the bank's credit provisions are likely to be higher than its operating profits, thereby resulting in net losses in FY2020 as well, with the RoA expected to be negative at ~0.8-1.2% for FY2020. The extent of recovery from the resolution of accounts under the NCLT will continue to drive the level of losses and capital required for FY2020.

Liquidity position

Based on the structural liquidity statement as on March 31, 2019, UCO reported a negative cumulative mismatch in the less than 1-year maturity bucket of -8.22% of the total assets due to the higher share of deposits maturing within one year. However, given its strong franchise and GoI ownership, ICRA expects the bank to roll over its deposits and plug the mismatches to maintain a comfortable liquidity profile. UCO's SLR holding was 29.2% of net demand and time liabilities (NDTL) as on March 29, 2019 against the regulatory requirement of 19.25%, which can be utilised to avail liquidity support from the RBI. The bank had excess SLR of Rs. 19,336 crore (9.9% of NDTL) as on March 29, 2019. This also provides liquidity cushion for the bank. Its daily average liquidity coverage ratio remained strong at 213.18% in FY2019 against the regulatory requirement of 100% as on January 1, 2019. The bank can also avail liquidity support from the RBI (through reverse repo against excess SLR investments and the marginal standing facility scheme) in case of urgent liquidity needs.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA Rating Methodology for Banks Impact of Parent or Group Support on an Issuer's Credit Rating
Parent/Group Support	The ratings factor in UCO's sovereign ownership and demonstrated track record of capital infusion by the GoI. ICRA expects the GoI to support UCO with capital infusions.
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the standalone financials of UCO.

About the company

UCO Bank was established in 1943 as United Commercial Bank and was nationalised in 1969. The bank was wholly owned by the GoI until September 2003, when an initial public offer led to a reduction in the GoI's stake to 75%. As on June 30, 2019, the GoI had a 92.52% stake in the bank. As on June 30, 2019, the bank operated 3,088 branches, including one branch in Hong Kong and one in Singapore. UCO is focussed on the rural and semi-urban segments, with around 61% of its branches being in these areas. It operated 2,358 ATMs as on March 31, 2019.

In FY2019, the bank reported a net loss of Rs. 4,321 crore on an asset base of Rs. 2,28,134 crore compared to a net loss of Rs. 4,436 crore on an asset base of Rs. 2,13,704 crore in FY2018. In Q1 FY2020, the bank posted a net loss of Rs. 601 crore compared to a net loss of Rs. 634 crore in Q1 FY2019. As on June 30, 2019, UCO's capital adequacy ratio was 10.88% (Tier I: 8.32%; both Basel III), while its gross and net NPAs stood at 24.86% and 8.98%, respectively.

Key financial indicators - Standalone

	FY2018	FY2019	Q1 FY2019	Q1 FY2020
Net interest income	3,125	4,311	1,228	1,335
Profit before tax	(4,427)	(4,306)	(599)	(601)
Profit after tax	(4,436)	(4,321)	(634)	(601)
Net advances	1,07,470	99,314	98,573	97,744
Total assets (excluding revaluation reserves)	2,13,704	2,28,134	2,04,414	2,23,987
% CET 1	8.23%	8.64%	7.02%	8.32%
% Tier 1	8.94%	8.64%	7.02%	8.32%
% CRAR	10.94%	10.70%	9.18%	10.88%
% Net interest margin / Average total assets	1.41%	1.95%	2.35%	2.36%
% Net profit / Average total assets	-2.00%	-1.96%	-1.21%	-1.06%
% Return on net worth	-35.19%	-28.73%	-20.63%	-15.31%
% Gross NPAs	24.64%	25.00%	25.72%	24.86%
% Net NPAs	13.10%	9.72%	12.74%	8.98%
% Provision coverage excl. technical write-offs	53.90%	67.71%	57.84%	70.16%
% Net NPA/ Net worth	111.71%	64.16%	104.90%	53.62%

Amounts in Rs. crore; Net worth excludes revaluation reserves

Source: UCO Bank, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

			Current Rating (FY2020)			Chronology of Rating History for the Past 3 Years							
					Date & Rating in FY2020	Date & Rating in FY2019			Date & Rating in FY2018		Date & Rating in FY2017		
Sl. No	Instrument	Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Aug 2019	Nov 2018	July 2018	May 2018	Aug 2017	June 2017	June 2016	May 2016	April 2016
1	Lower Tier II Bonds	Long Term	800.00	800.00	[ICRA] A+ (Negative)	[ICRA] A+ (Negative)	[ICRA] A+ (Negative)	[ICRA] A+ (Negative)	[ICRA] A+ (Negative)	[ICRA] A+ (Negative)	[ICRA] AA- (Negative)	[ICRA] AA- (Negative)	[ICRA] AA (Negative)
2	Upper Tier II Bonds	Long Term	500.00	500.00	[ICRA] A- (Negative)	[ICRA] A- &	[ICRA] A- (Negative)	[ICRA] A- (Negative)	[ICRA] A- (Negative)	[ICRA] A- (Negative)	[ICRA] A (Negative)	[ICRA] A+ (Negative)	[ICRA] AA- (Negative)

& Under Rating Watch with Developing Implications

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	Instrument Name	Date of Issuance / Allotment	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE691A09169	Lower Tier II Bonds	08-Mar-2010	8.92%	08-Mar-2020	800.00	[ICRA]A+(Negative)
INE691A09177	Upper Tier II Bond	25-Mar-2010	8.90%	25-Mar-2025 (Call:25-Mar-2020)	500.00	[ICRA]A-(Negative)

Source: UCO Bank, ICRA research

ANALYST CONTACTS

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

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

Niraj Jalan
+91 33 7150 1146
niraj.jalan@icraindia.com

Prateek Mittal
+91 33 7150 1132
prateek.mittal@icraindia.com

RELATIONSHIP CONTACT

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

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.

For more information, visit www.icra.in

ICRA Limited

Corporate Office
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300
Email: info@icraindia.com
Website: www.icra.in

Registered Office
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

Mumbai	+ (91 22) 24331046/53/62/74/86/87
Chennai	+ (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,
Kolkata	+ (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,
Bangalore	+ (91 80) 2559 7401/4049
Ahmedabad	+ (91 79) 2658 4924/5049/2008
Hyderabad	+ (91 40) 2373 5061/7251
Pune	+ (91 20) 2556 0194/ 6606 9999