August 23, 2019

PNB Gilts Limited: Rating reaffirmed

Summary of rating action

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*

Rationale

The rating factors in PNB Gilts' strong capitalisation profile, large 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) for primary dealers (PDs). Further, the company has adequate internal prudential norms and risk management policies, which mitigate the market risks arising out of interest rate movements, which are intrinsic to a PD's business. Punjab National Bank (PNB, rated [ICRA]AA-(Stable)/[ICRA]A1+) is the largest shareholder of PNB Gilts and provides managerial, operational and liquidity support to the company.

ICRA notes the less-diversified revenue stream of PNB Gilts and high reliance on interest income and trading income. ICRA further notes the susceptibility of the company's overall profitability and capitalisation profile to interest rate movements. With a decline in bond yields in H2 FY2019 and Q1 FY2020, PNB Gilts reported an improvement in trading profits. This, coupled with higher leverage (hence a higher investment portfolio) and a cut in the repo rate, boosted the overall net interest income (NII) in FY2019. Accordingly, the profitability improved with a return on net worth of 5.96% in FY2019 (~0.16% in FY2018) and 19.21% (annualised) in Q1 FY2020 (~-21.65%[1] in Q1 FY2019).

In Q1 FY2020, the company had to provide for mark-to-market (MTM) provisions on certain corporate bond investments, which stood at ~5% of its net owned funds (NOF). However, the continued decline in bond yields and consequent gains on the bond portfolio largely offset these provisions, resulting in improved profitability in Q1 FY2020. With a benign inflation outlook, the interest rate environment looks favourable for FY2020 and should provide PNB Gilts with enough trading opportunities. Its ability to capture these opportunities will drive its overall profitability, even as limited diversification of its revenue stream will mean high dependence of overall profitability on NII and trading profits.

Rating sensitivities

PNB Gilts' ability to manage volatility in interest rates while adhering to its risk management policies will remain a key driver of its profitability, even though the strong capitalisation profile will provide a cushion against adverse movements in interest rates and consequent losses. These apart, the continuity of management control by PNB, any adverse change

[1] *The loss in Q1 FY2019 was also because of the MTM losses on the held-to-maturity (HTM) investment book on transition to Ind-AS, apart from rising bond yields*

in the regulatory framework for PDs, and maintenance of a high quality and diversified corporate investment book to minimise the credit losses will remain rating sensitivities.

Key rating drivers

Credit strengths

Strong capital profile – PNB Gilts' capital adequacy remains strong with its capital to risk weighted assets ratio (CRAR) at 38.18% as on June 30, 2019 (47.64% as on June 30, 2018 and 36.58% as on March 31, 2019), well above the regulatory minimum of 15% for PDs. The decline in CRAR in the last one year was because of an increase in the market risk on the investment portfolio, which, in turn, resulted from an increase in the duration and leverage of the bond portfolio over the last one year. This, in turn, was because of an increase in the permissible leverage, as per the internal business policy, in FY2020 to capitalise on market opportunities. Notwithstanding the increase in market risk, a sizeable net worth provides PNB Gilts with a comfortable cushion to absorb any significant shocks in the interest rates. As on June 30, 2019, the company had a net worth of ~Rs. 937 crore (NOF of ~Rs. 936 crore), and the price value of basis point (PVBP)[2] stood at Rs. 2.96 crore, indicating its ability to absorb large adverse movements of 316 basis points (bps) in interest rates.

Comfortable liquidity with large portfolio of G-Secs and highly rated corporate debt securities – The company has a large portfolio of highly liquid government securities (G-Secs, state development loans (SDL) and GoI treasury bills (T-bills)). As on June 30, 2019, investment in G-Secs comprised ~84% of the total assets (Rs. 8,171 crore) against ~72% as of March 31, 2019, (Rs. 6,584 crore). On a daily average basis, the G-Secs accounted for 87% of the company's total borrowings in FY2019 (87% in FY2018) and 90% in Q1 FY2020. The other assets include investments in highly rated corporate bonds.

PNB Gilts' non-SLR or corporate debt investment portfolio has also remained well diversified across highly rated corporates and limited in relation to its NOF. Typically, the corporate debt investments remain below Rs. 1,500 crore on a daily average basis during the year, which is limited in relation to its NOF of ~Rs. 936 crore as on June 30, 2019 and can be easily funded through notice/term money, commercial paper, inter-corporate deposits or bank lines. These investments can also be sold off to generate liquidity if required. With funds parked in highly liquid investments, the overall liquidity of PNB Gilts remains comfortable.

PNB Gilts' liquidity is also supported by its access to the money market for call and repo borrowings, in addition to the RBI's LAF. Additionally, the company has sanctioned bank limits of Rs. 1,500 crore from PNB (including committed bank lines of Rs. 900 crore). Though the company's liabilities are largely short term in nature compared to the long tenure of the assets, the liquid nature of the assets mitigates the asset-liability risk. PNB Gilts continues to fulfil its regulatory bidding commitments at the primary auctions with minimum success and turnover ratio requirements for dated G-Secs and T-bills.

Adequate risk management systems – Being a PD, PNB Gilts faces significant risks because of adverse interest rate movements as well as the exposure to credit risk in non-SLR debt instruments. In this regard, prudent risk management policies and adherence to the same are 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

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

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. While the approved VaR is less than 10% of the net worth, the actual VaR remained within the approved limits in FY2019 and Q1 FY2020.

Credit challenges

Low diversity in revenue streams – PNB Gilts' revenue stream is relatively less diversified compared to other PDs, with interest income and trading income accounting for almost ~99% of its total revenue. Therefore, profitability is greatly impacted by adverse interest rate movements. A sizeable increase in fee-based income can provide a cushion to the company's profitability, making it less sensitive to interest rate movements in future.

Profitability to remain dependent on interest rate movements and asset quality of non-SLR investment book – PNB Gilts' total portfolio mainly comprises debt securities. As a result, its profitability profile is highly dependent on interest rate movements. This is reflected in the sizeable variation in trading profits in H1 FY2019 and H2 FY2019 because of movements in bond yields (trading loss including MTM gains/losses of ~Rs. 58 crore in H1 FY2019 and trading profit of ~Rs. 61 crore in H2 FY2019). In Q1 FY2020, the company had to provide for MTM provisions on certain corporate bond investments, which stood at ~5% of its NOF. However, the continued decline in bond yields and consequent gains on the bond portfolio largely offset these provisions, resulting in improved profitability in Q1 FY2020.

Apart from trading income, the NII is driven by the interest rate environment. With a series of repo rate cuts by the RBI and higher leverage, PNB Gilts' NII improved to ~Rs. 99 crore in FY2019 from ~Rs. 70 crore in FY2018. It increased further to ~Rs. 42 crore in Q1 FY2020 (~Rs. 19 crore in Q1 FY2019) because of benign interest rates on borrowings and higher leverage leading to higher interest income on the investment portfolio. With increase in trading profits (including MTM gains/losses) and higher NII, PNB Gilts reported a net profit of Rs. 52.86 crore in FY2019 compared to Rs. 1.41 crore in FY2018.

Earlier in Q1 FY2019, PNB Gilts also had to recognise the MTM loss on its investments in the HTM book on transitioning to Ind-AS, which impacted its profitability in FY2019. The trading profits and NII will remain susceptible to any probable volatility in short-term interest rates, which would then impact its overall profitability.

Going forward, with a benign inflation outlook, the interest rate environment looks favourable for FY2020 and should provide PNB Gilts with enough trading opportunities. The ability to capture these opportunities will drive its overall profitability, even as limited diversification of its revenue stream will mean high dependence on NII and trading profits for overall profitability.

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

Liquidity position

Being a PD, the majority of the company's investments are in highly liquid G-Secs (GoI bonds, SDLs and T-bills). As of June 30, 2019, 86% of the investments were in highly liquid G-Secs, equivalent to ~94% of the total borrowings, while the rest were in highly rated corporate debt securities which can be liquidated, if required. 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.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	[Rating Methodology for Primary Dealers](#)
Parent/Group Support	The rating factors in the operational, managerial and liquidity support provided by its promoter – Punjab National Bank
Consolidation/Standalone	To arrive at the rating, ICRA has considered the standalone financials of the company

About the company

PNB Gilts is a primary dealer in the Government securities market. It was incorporated as a wholly-owned subsidiary of Punjab National Bank and 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, PSU bonds, inter-corporate deposits, gilt accounts, money market instruments and investment/trading in equity and equity derivatives. In addition, it offers advisory services to clients to manage the G-Sec portfolios. In July 2000, the company launched an initial public offering (IPO), thereby reducing PNB's stake to 74.07%.

In FY2019, the company made a profit after tax of Rs. 52.86 crore on total income of Rs. 508.01 crore compared to a profit after tax of Rs. 1.41 crore on total income of Rs. 402.45 crore in FY2018. PNB Gilts achieved a success ratio[3] of 41.16% in H1 FY2019 (42.48% in H1 FY2018) and 40.40% in H2 FY2019 (40.91% in H2 FY2018) in the T-bills market, above the regulatory requirement of 40%. Further, a turnover ratio[4] of 303 times (284 times in FY2018) in case of dated G-Secs and 179 times (83 times in FY2018) in case of T-bills was achieved in FY2019.

Key financial indicators (audited)

	FY2018	FY2019	Q1 FY2019	Q1 FY2020*
Net Interest Income (NII)	70	99	19	42
Trading Profits	-51	3	-58	31
Underwriting & Other Income	2	3	1	1
Operating Costs	19	22	5	6
Profit before Tax	1.32	83	-43	67
Profit after Tax (PAT)	1.41	53	-44	45
Net Worth	881	888	813	937
Borrowings	4,369	8,234	5,902	8,719
Stock-in-Trade	4,999	8,818	6,359	9,498
Total Assets	5,252	9,522	6,756	9,677
PAT/ATA	0.03%	0.72%	-2.52%	2.00%
PAT/Net Worth (RoNW)	0.16%	5.96%	-21.65%	19.21%
Total Debt / Net Worth (times)	4.96	5.97	6.91	9.31

[3] *Success ratio is defined as Bids accepted / Bids commitment*

[4] *Turnover ratio – Total purchase and sales during the year in the secondary market/average month-end stocks*

Amounts in Rs. crore; Figures as per ICRA research
Source: PNB Gilts, ICRA research
** Q1 FY2020 results are unaudited*

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	Date & Rating in FY2019	Date & Rating in FY2018		Date & Rating in FY2017
Instrument	**Type**	**Amount Rated (Rs. crore)**	**Amount Outstanding (Rs. crore)**	**August 2019**	**September 2018**	**February 2018**	**August 2017**	**-**
Commercial Paper	Short Term	500.00	-	[ICRA]A1+; Reaffirmed	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	-

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 / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
-	Commercial Paper Programme	-	-	7-365 days	500.00	[ICRA]A1+

Source: PNB Gilts

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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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