September 19, 2019

Punjab National Bank: Ratings placed on Watch with Positive Implications

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Compliant Tier II Bonds	1,000.00	1,000.00	[ICRA]AA- (hyb) %; Placed on rating Watch with Positive Implications
Infrastructure Bonds	3,000.00	3,000.00	[ICRA]AA- %; Placed on rating Watch with Positive Implications
Fixed Deposits Programme	-	-	MAA %; Placed on rating Watch with Positive Implications
Certificates of Deposit	60,000.00	60,000.00	[ICRA]A1+; Outstanding
Total	**64,000.00**	**64,000.00**	

% Rating watch with Positive Implications
**Instrument details are provided in Annexure-1*

Rationale

On August 30, 2019, the Government of India (GoI) announced the merger of 10 public sector banks (PSBs) into four entities with a proposed capital infusion of Rs. 59,807 crore into 11 banks[1] and measures to improve the corporate governance standards of banks.

As a part of the announcement, the GoI has proposed the merger of Punjab National Bank (PNB), Oriental Bank of Commerce (OBC; rated [ICRA]A+ %) and United Bank of India (not rated by ICRA), subject to approval by the respective boards of the banks[2]. The merger, upon implementation (the merged entity is referred to as PNB-M henceforth), is expected to create the second-largest PSB in India in terms of business (net advances and deposits) of Rs. 16.84 lakh crore (as on June 30, 2019) and the second-largest branch network in India with 11,437 branches as on June 30, 2019. In addition to the merger announcement, the GoI announced a proposed capital infusion of Rs. 16,000 crore in PNB and Rs. 1,600 crore in United Bank, while no capital infusion was announced for OBC, given its relatively better capital position.

The rating watch considers the proposed capital infusion in PNB by the GoI for FY2020, which is expected to shore up the capital ratios while enabling the bank to create provisions on its stressed assets. This will drive an improvement in its asset quality and solvency, thereby improving its credit profile. Following the proposed capital infusion, even in a stressed scenario of gross fresh slippages at 4.5-5.0% (of standard advances as on March 31, 2019), ICRA expects PNB (on a standalone basis) to be able to increase its provision cover on its stock of gross NPAs (GNPAs) and reduce the net NPAs (NNPA) to less than 5% by March 31, 2020, while maintaining a sizeable capital cushion over the regulatory capital ratios. This is despite expectations of weak internal capital generation with an expected return on net worth (RoNW) of 0.8-1.9% in FY2020. Supported by lower NNPAs and an improved capital position, ICRA expects PNB's solvency profile, as

[1] GoI subsequently announced a capital infusion of Rs. 4,557 crore in IDBI Bank Limited, rated [ICRA]A(Negative) for Tier II bonds
[2] The board of all the three banks have since then, accorded their in-principal approval for the merger

reflected by NNPA/CET, to improve to ~53% by March 31, 2020 (117.70% as on June 30, 2019), though it will be weaker than its peer PSBs.

The ratings continue to be supported by PNB's sovereign ownership, its established presence and branch network along with its strong deposit profile. PNB is the third-largest PSB and the sixth-largest bank in the Indian banking sector in terms of asset size as on June 30, 2019. With a well-established retail franchise, supported by 7,036 branches as on June 30, 2019, it continues to maintain a stable and high current account and savings account (CASA) deposit base. As a result, the cost of interest-bearing funds remains below the PSB average.

Further, the ratings watch factors in the expected implication of the proposed merger with OBC and United Bank. ICRA expects the merged entity to be better placed on the capital, solvency and asset quality front compared to the current standalone profile of PNB. ICRA expects the merged entity to have NNPAs below ~4.5% by March 2020 against 6.96% as on June 30, 2019 and solvency (NNPAs/CET) of ~53% by March 31, 2020 (96% as on June 30, 2019).

The earnings profile of the merged entity is, however, expected to remain weak because of expectations of losses for OBC and United Bank. Though ICRA expects that PNB will not require equity capital on a standalone basis to support its growth and for the maintenance of capital cushions in FY2020, it expects PNB to raise additional capital before the merger to maintain the capital cushions on a merged basis. The incremental capital requirement should, however, be manageable in ICRA's view and can be met by market raising or the divestment of non-core assets. ICRA will continue to monitor the size of the capital raising as well as the capital and solvency levels maintained by the merged entity. The rating watch will be resolved as and when more clarity emerges on the capital, solvency and asset quality profile of the merged entity.

Key rating drivers and their description

Credit strengths

Sovereign ownership – With an equity stake of 75.41% as on June 30, 2019, the GoI accounts for majority ownership in PNB. The bank has witnessed strong capital support from the GoI in the past with infusions of Rs. 5,473 crore in FY2018 and Rs. 14,156 crore in FY2019. The proposed infusion of Rs. 16,000 crore in FY2020 is the highest for any PSB in FY2020 and should support a significant improvement in the bank's asset quality profile as well as capital position. As per ICRA's estimates, while no capital requirement is expected for PNB, the merged entity's capital requirement for FY2020 can be met by market raising or divestments, thus entailing limited dependence on the GoI going forward. On a merged basis, the GoI will continue to have majority ownership even though its shareholding will depend on the swap ratio announced by the banks.

Strong CASA deposit base results in lower cost of funds – At a share of 42.84% of the domestic deposit base as on June 30, 2019, PNB's low-cost CASA share is higher than the average PSB CASA share (~38.5%) or system CASA (~38.8%). The strong CASA deposit base is supported by the widespread network of 7,036 branches as on June 30, 2019, resulting in an established retail franchise. This leads to a granular deposit base, as reflected by the top 20 depositors accounting for 3.23% as on March 31, 2019 against 4.91% as on March 31, 2018. Thus, supported by the higher CASA share and granular deposit base, PNB's cost of funds at 5.05% in Q1 FY2019 was lower than the PSB average of 5.12% (4.82% for FY2019 against the PSB average of 5.01%).

In ICRA's view, the merged entity will be well placed on CASA deposits, supported by the high share of CASA in PNB and United Bank. This will translate into lower cost of funds and will be a key driver of the merged entity's profitability.

Likely to be classified as SIB upon merger – Upon merger, PNB will be the second-largest PSB in terms of advances after State Bank of India (rated [ICRA]AAA(Stable) for Tier II bonds) and will account for ~7.2% of banking sector advances as on June 30, 2019. The bank will also have the second-largest branch network (11,437 branches as on June 30, 2019). Given the significant increase in its scale of operations, ICRA expects the bank to be classified as a systemically important bank (SIB) by the Reserve Bank of India (RBI).

Credit challenges

Asset quality remains weak with elevated slippages – The fresh slippage rate (annualised) for the bank continued to decline in Q1 FY2020 though it remained high. PNB reported fresh slippages of Rs. 5,412 crore in Q1 FY2020 (annualised slippage rate of 5.1%) against slippage rate of 6.3% in FY2019. Supported by stable recoveries and upgrades of Rs. 3,859 crore (4.9% of GNPA) and write-offs of Rs. 2,758 crore, the GNPA declined to Rs. 77,267 crore as on June 30, 2019 from Rs. 78,473 crore as on March 31, 2019. Despite the decline, the GNPA percentage increased to 16.49% as on June 30, 2019 from 15.50% as on March 31, 2019 because of a degrowth in advances. The provision coverage ratio (PCR), without write-offs, declined sequentially to 60.9% as on June 30, 2019 from 61.7% as on March 31, 2019 because of lower provisions on incremental slippages. Despite the lower GNPAs, the NNPAs increased marginally to Rs. 30,180 crore (7.17%) as on June 30, 2019 from Rs. 30,038 crore (6.56%) as on March 31, 2019 as the PCR declined.

With estimates of a slippage rate of 4.5-5% and a PCR of 75-76% by March 31, 2020, ICRA expects the NPPAs to decline to 4.25-4.50%, with the bank maintaining sufficient capital cushion above the regulatory requirements. The solvency is expected to improve to ~53% as on March 31, 2020 from 117.7% as on June 30, 2019 on the back of lower NPAs and an improved capital position.

The merged entity's GNPAs and NNPAs stood at 15.48% and 6.96%, respectively, as on June 30, 2019, because of the relatively better asset quality of OBC. To align the asset quality and provisioning levels of the merging entities with PNB, ICRA expects the credit provisioning for the merged entity to remain high. Hence, the capital cushions for the merged entity will be relatively lower than standalone PNB.

Profitability expected to improve but remain weak in FY2020 – PNB's operating profit declined in Q1 FY2020 to Rs. 3,481 crore (1.82% of ATA) from Rs. 3,978 crore for Q1 FY2019 (2.13% of ATA). The decline resulted from degrowth in the bank's net interest income (NII) to Rs. 4,141 crore in Q1 FY2020 from Rs. 4,692 crore in Q1 FY2019 (large NCLT recoveries in Q1 FY2019 supported higher NII). Thus, net interest margins (NIMs) declined to 2.17% in Q1 FY2020 from 2.51% in Q1 FY2019. Despite the lower operating profits, PNB reported a profit after tax (PAT) of Rs. 1,019 crore in Q1 FY2020 against a loss after tax of Rs. 941 crore in Q1 FY2019 because of a decline in credit provisions to Rs. 2,147 crore (1.12% of ATA) in Q1 FY2020 from Rs. 4,958 crore (2.65%) in Q1 FY2019. The merged entity also reported a net profit of Rs. 1,236 crore (RoA of 0.42%) in Q1 FY2020.

Given the NNPAs of 6.96% and weak solvency of 96% for the merged entity as of June 2019, ICRA expects the provisioning to remain high at 2.7-2.9% of advances, which will result in weak RoA of ~-0.2%.

Capital ratios expected to be restored above regulatory levels; however, cushions likely to remain limited for merged entity – Asset quality pressure has resulted in large losses for PNB in FY2018 and FY2019, significantly weakening its capital ratios. Despite reporting a profit in Q1 FY2020, PNB's capital ratios remained weak with CET 1, Tier 1 and CRAR of 6.35%, 7.64% and 9.77%, respectively, as on June 30, 2019. Moreover, the bank was not maintaining the capital conservation buffer (CCB). With the proposed capital infusion of Rs. 16,000 crore in FY2020 by the GoI, ICRA expects PNB to be able to meet the regulatory capital ratios (including CCBs) with a healthy cushion as on March 31, 2020.

For the merged entity, with expected growth of 8-10% in risk weighted assets in FY2020, increasing regulatory capital requirement from March 31, 2020 and limited internal capital generation, ICRA expects the Tier 1 capital cushion to remain limited. To maintain a 50-bps cushion over the regulatory capital ratios, the bank may need to raise capital of up to Rs. 2,400 crore (~8% of PNB's market cap) in FY2020, which can be also met through the divestment of non-core assets. The extent of capital cushion and the solvency level will remain key rating drivers for the merged entity.

Liquidity position: Strong

Supported by its established retail franchise and hence the high share of stable deposits, PNB's liquidity coverage ratio (LCR) remained comfortable at 155.37% as on June 30, 2019 (on a consolidated basis[3]) against the regulatory requirement of 100%. As per the structural liquidity statement as on March 31, 2019, the bank had positive cumulative mismatches across most of the maturity buckets and the negative cumulative mismatch was limited to ~2.7% (of the total outflows) in the up to 1-year bucket. ICRA expects PNB to maintain **strong** liquidity, given the steady core deposit base of CASA and retail deposits. Moreover, as per ICRA's estimates, the bank held excess SLR of 3.1% of the global deposits as on June 30, 2019, providing further liquidity cushion. 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.

Rating sensitivities

Positive triggers – Given the positive watch, ICRA could upgrade the ratings if the merged entity's NNPAs fall below 5% and the solvency profile improves with NNPA/CET of less than 50%, while the capital cushions are maintained above the regulatory levels on a sustained basis.

Negative triggers – ICRA could assign a Negative outlook and/or downgrade the ratings if the solvency profile of the merged entity is weak with NNPAs of >6% and/or solvency (NNPA/CET) of >65-70% on a sustained basis.

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	Parent/Group Company: Sovereign ownership The ratings factor in PNB's sovereign ownership and demonstrated track record of capital infusion by the GoI
Consolidation/Standalone	To arrive at the ratings, ICRA has considered the standalone financials of PNB as well as the merged financials of PNB, OBC and United Bank

About the company

Punjab National Bank (PNB) was incorporated as Punjab National Bank Limited in 1894 and commenced operations in Lahore in April 1895. Upon nationalisation in 1969, the bank was renamed Punjab National Bank. As on June 30, 2019,

[3] *Includes domestic and foreign subsidiaries*

the GoI held 75.41% equity in the bank. As on December 31, 2018, PNB had 7,036 domestic branches and 8,906 ATMs. The bank has a strong presence in rural and semi-urban areas, where around 62% of its branches were located as on June 30, 2019. PNB reported a profit after tax of Rs. 1,019 crore in Q1 FY2020 on a total asset base of Rs. 7.58 lakh crore as on June 30, 2019 against a loss after tax of Rs. 941 crore in Q1 FY2019 on a total asset base of Rs. 7.34 lakh crore as on June 30, 2018. PNB's gross and net NPAs stood at 16.49% and 7.17%, respectively, as on June 30, 2019. It reported Tier 1 capital of 7.64% and CRAR of 9.77% as on June 30, 2019.

Key financial indicators (audited) – Punjab National Bank

	FY2018	FY2019	Q1 FY2019	Q1 FY2020
Net interest income	14,922	17,156	4,692	4,141
Profit before tax	-19,575	-15,347	-1,564	1,458
Profit after tax	-12,282	-9,976	-941	1,019
Net advances	4,33,735	4,58,249	4,15,339	4,21,794
Total assets	7,62,146	7,72,259	7,34,143	7,57,963
% CET 1	5.95%	6.21%	6.05%	6.35%
% Tier 1	7.12%	7.49%	7.33%	7.64%
% CRAR	9.20%	9.73%	9.62%	9.77%
% Net interest margin	2.02%	2.24%	2.51%	2.17%
% PAT / ATA	-1.66%	-1.30%	-0.50%	0.53%
% Return on net worth	-32.43%	-25.10%	-10.19%	9.56%
% Gross NPAs	18.38%	15.50%	18.26%	16.49%
% Net NPAs	11.24%	6.56%	10.58%	7.17%
% Provision coverage excl. technical write-offs	43.80%	61.72%	47.07%	60.94%
% Net NPA/ CET	180.5%	119.6%	143.5%	117.7%

Note: Amount in Rs. crore; Net worth and total assets exclude revaluation reserves
Source: PNB, ICRA research
All calculations are as per ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2020) Type	Amount Rated	Amount Outstanding	Rating 19-Sep-2019	Rating History for the Past 3 Years FY2019 13-Mar-2019	22-May-2018	FY2018 13-Mar-2018	19-Feb-2018	15-Jun-2017	26-Apr-2017	FY2017 24-Feb-2016	14-Aug-2015
1	Basel III Compliant Tier II Bonds Programme	Long Term	1,000.00	1,000.00	[ICRA]AA-(hyb) %	[ICRA]AA-(hyb) (Stable)	[ICRA]AA-(hyb) (Negative)	[ICRA]AA+(hyb)@	[ICRA]AA+(hyb)@	[ICRA]AA+(hyb) (Stable)	[ICRA]AA+(hyb) (Stable)	[ICRA]AA+(hyb) (Stable)	[ICRA]AAA (hyb) (Stable)
2	Infrastructure Bonds Programme	Long Term	3,000.00	1,800.00^	[ICRA]AA-%	[ICRA]AA-(Stable)	[ICRA]AA-(Negative)	[ICRA]AA+@	[ICRA]AA+@	[ICRA]AA+(Stable)	[ICRA]AA+(Stable)	ICRA] AA+(Stable)	[ICRA]AAA (Stable)
3	Certificates of Deposit Programme	Short Term	60,000.00	NA	[ICRA]A1+ O/S	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
4	Term Deposits Programme	Medium Term	NA	NA	MAA %	MAA (Stable)	MAA (Negative)	MAAA@	MAAA@	MAAA (Stable)	MAAA (Stable)	MAAA (Stable)	MAAA (Stable)

^ Rs. 1,200 crore of bonds yet to be placed
% Rating on Watch with Positive Implications
@ Ratings on Watch with Negative Implications
Amount in Rs. crore

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
INE160A08019	Basel III Compliant Tier II Bonds Programme	February 24, 2014	9.65%	February 24, 2024	1,000.00	[ICRA]AA- (hyb) %
INE160A08084	Infrastructure Bonds	March 24, 2015	8.35%	March 24, 2025	1,800.00	[ICRA]AA- %
-	Infrastructure Bonds	Not placed	-	-	1,200.00	[ICRA]AA- %
NA	Certificates of Deposit Programme	-	-	7-365 days	60,000.00	[ICRA]A1+
NA	Term Deposits Programme	-	-	-	-	MAA %

Source: PNB
% Rating on Watch with Positive Implications

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