September 19, 2019

Oriental Bank of Commerce: 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 Programme	3,000.00	3,000.00	[ICRA]A+ (hyb) %; Placed on rating Watch with Positive Implications
Basel II Compliant Lower Tier II Bonds Programme	1,200.00	1,200.00	[ICRA]A+ %; Placed on rating Watch with Positive Implications
Total	**4,200.00**	**4,200.00**	

% Denotes under rating Watch with Positive Implications
**Instrument details are provided in Annexure-1*

Rationale

On August 30, 2019, the Ministry of Finance announced a slew of banking reform measures aimed at increasing the efficiency of public sector banks (PSBs). These reforms include the merger of 10 PSBs into four entities, a proposed capital infusion of Rs. 59,807 crore into 11 banks[1] and measures to improve the corporate governance standards in banks.

As a part of the merger announcement, the Ministry proposed the merger of Punjab National Bank (PNB; rated [ICRA]AA-% for Tier II bonds), Oriental Bank of Commerce (OBC) and United Bank of India (not rated by ICRA), subject to approval by the respective boards of the banks[2]. Upon implementation, the merger (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, which is a relatively better capitalised bank.

Further, the ratings watch factors in the expected implication of the proposed merger of OBC with PNB 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 OBC. ICRA expects the merged entity to have net NPAs (NNPAs) below ~4.5% by March 2020 against 5.91% for OBC as on June 30, 2019 and solvency (NNPAs/CET) of ~53% by March 31, 2020 against 61% for OBC 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. The incremental capital requirement for the merged entity should be manageable, in ICRA's view, and can be met by market raising or divestment of non-core assets. ICRA will continue to monitor the size of the capital raising by the merged entity and its capital and solvency levels. The rating watch will be resolved as and when more clarity emerges on the capital, solvency and asset quality profile of the merged entity.

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[1] GoI subsequently announced a capital infusion of Rs. 4,557 crore in IDBI in FY2020
[2] The board of all the three banks have since then, accorded their in-principal approval for the merger

Key rating drivers and their description

Credit strengths

GoI ownership with demonstrated capital support – OBC has a majority sovereign ownership with the GoI holding 87.58% as on June 30, 2019. The GoI has demonstrated funding support to the bank in the past, infusing Rs. 3,571 crore in FY2018 and Rs. 6,686 crore in FY2019 (post which the bank exited the Reserve Bank of India's (RBI) prompt corrective action (PCA) framework). As per ICRA's estimates, while no capital requirement is expected for PNB, the merged entity's capital requirement for FY2020 can be met through 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 of the merged entity even though its shareholding will depend on the swap ratio announced by the banks.

Steady deposits profile; however, cost of funds higher than PSB average given relatively lower CASA share – OBC has a stable core deposit profile supported by its network of 2,390 branches as on June 30, 2019, with ~50% located in semi-urban and rural areas. Thus, OBC's low-cost current account and savings account (CASA) deposits grew 5.4% YoY to Rs. 66,754 crore as on June 30, 2019. Since exiting the RBI's PCA framework, the bank has pursued credit growth, thereby entailing large deposit mobilisation. Accordingly, deposit growth was higher at 15.7% YoY as on June 30, 2019, resulting in a decline in the CASA share to 28.73% from 31.40% as on June 30, 2018, thus remaining below the PSB and system averages. As the CASA share declined, the cost of interest-bearing funds increased to 6.10% in Q1 FY2020 from 5.73% in Q1 FY2019. The deposit base has become more granular, driven by the established franchise, as reflected by a decline in the share of the top 20 depositors to 12.62% as on March 31, 2019 from 13.20% as on March 31, 2018.

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 profitability of the merged entity.

Improved capital cushions post recapitalisation by GoI in FY2019 – Upon large recapitalisation by the GoI in FY2019, OBC's capital position improved significantly. Supported by improved accruals and sequential RWA degrowth as on June 30, 2019, OBC's capital ratios improved, with CET I, Tier I and CRAR at 10.81%, 10.94% and 13.77%, respectively as on June 30, 2019.

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 I capital cushion to remain limited. To maintain a 50-bps cushion over the regulatory levels, the merged entity may need to raise capital of up to Rs. 2,400 crore in FY2020, which can be also met through the divestment of non-core assets. The extent of capital cushions and the solvency levels will remain key rating drivers for the merged entity.

Likely to be classified as SIB upon merger – Upon merger, the merged entity 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 the scale of operations, ICRA expects the merged entity to be classified as a systemically important bank (SIB) by the RBI.

Credit challenges

Despite improvement, asset quality and solvency remain weak – OBC's asset quality profile improved in Q1 FY2020 with reported GNPA and NNPA at 12.56% and 5.91%, respectively, as on June 30, 2019. This was driven by a lower slippage rate, with an annualised slippage rate of 3.8% in Q1 FY2020 against 5.8% in FY2019, despite muted recoveries and upgradation. Additionally, with sizeable write-offs, the bank was able to reduce its GNPA over the last four quarters to Rs. 21,369 crore as on June 30, 2019 from Rs. 26,141 crore as on June 30, 2018 (Rs. 21,717 crore as on March 31, 2019). With a decline in GNPAs and a stable provision cover, NNPAs declined to Rs. 9,343 crore as on June 30, 2019 from Rs. 9,440 crore as on March 31, 2019. The reduction in NNPAs and improved capital position led to an improvement in solvency, as reflected by NNPA/CET of 61.1% as on June 30, 2019 compared to 140.1% as on June 30, 2018.

As per the guidance provided by the management, OBC's stressed portfolio stood at Rs. 4,600 crore (2.70% of gross advances) as on June 30, 2019. Of this, 34% comprised exposures to the NBFC sector while 16% was on account of power sector exposures, representing a potential source of slippages in FY2020. Going forward, with a slippage rate of 4-4.5% and a provision cover of 75-76% for FY2020, ICRA expects the NNPAs to fall below 4% by March 31, 2020 leading to an improvement in solvency to 46-47% by March 31, 2020.

OBC's GNPAs and NNPAs are lower than United Bank and PNB because of substantial write-offs taken by the bank in FY2019 to exit the PCA framework. Further, United Bank and PNB's solvency levels are also much weaker than OBC. However, with capital allocation to PNB and United Bank by the GoI prior to the merger, ICRA expects both banks to significantly provide for their NPAs, reduce their NNPAs and improve their solvency levels at the time of merger.

Profitability to remains weak in FY2020 – Despite higher earning assets and lower slippages (thus, lower income reversals), OBC reported marginal YoY growth in NII (3%) in Q1 FY2020 as large recoveries in National Company Law Tribunal (NCLT) accounts boosted the NII in Q1 FY2019. Despite the subdued NII growth, the bank's operating profit (excluding trading gains) registered 27% YoY growth as the cost-to-income ratio[3] improved to 56% in Q1 FY2020 from 62% for Q1 FY2019, supported by higher non-interest income (due to higher recovery in TWO accounts) and stable operating expenses. As the bank upfronted the credit provisions in FY2019 upon a large capital infusion by the GoI in FY2019 and reported lower slippages in Q1 FY2020 vis-à-vis Q1 FY2019, it reported a net profit in Q1 FY2020 against a net loss in the corresponding year-ago quarter. Going forward, ICRA expects the credit costs to increase to ~1.6-1.7% of ATA in FY2020, which will translate into losses in FY2020.

Liquidity position: Adequate

OBC's liquidity profile remained **adequate**, with a liquidity coverage ratio (LCR) of 116.45% (average for the quarter) as on March 31, 2019 against the regulatory requirement of 100%. As per ICRA's estimates, the bank held excess SLR of ~6.7% of the total deposits as on June 30, 2019, which supports its liquidity profile. However, as per the structural liquidity statement (SLS) as on June 30, 2019, the bank had a high negative cumulative mismatch of ~17.7% (as a percentage of total outflows) in the up to 1-year bucket. OBC will need to roll over its deposits to maintain its liquidity profile and it 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 NNPAs for the merged entity 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.

[3] *Cost to income ratio = Operating Cost/ Operating Income*

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 OBC's sovereign ownership and the demonstrated track record of capital infusion by the GoI
Consolidation/Standalone	To arrive at the ratings, ICRA has considered the standalone financials of OBC and the merged financials of PNB, OBC and United Bank

About the company

The GoI has a stake of 87.58% in OBC, which primarily operates in northern India. As of June 30, 2019, the bank's network comprised 2,390 branches and 2,620 ATMs, with ~50% of the branches located in rural and semi-urban areas. OBC reported a net profit of Rs. 113 crore in Q1 FY2020. Its asset base stood at Rs. 2.70 lakh crore as of June 30, 2019 against Rs. 2.26 lakh crore as on June 30, 2018. Its asset quality indicators i.e. GNPA and NNPA stood at 12.56% and 5.91%, respectively, as on June 30, 2019, against 17.89% and 10.63%, respectively, as on June 30, 2018. Its reported Tier I and CRAR stood at 10.94% and 13.77%, respectively, as on June 30, 2019 vis-à-vis 7.28% and 10.25%, respectively, as on June 30, 2018.

Key financial indicators (audited) – Oriental Bank of Commerce

	FY2018	FY2019	Q1 FY2019	Q1 FY2020
Net interest income	4,511	5,505	1,338	1,372
Profit before tax	-6,095	-3,631	-816	183
Profit after tax	-5,872	54	-394	113
Net advances	136,368	159,285	134,168	158,096
Total assets	231,939	270,408	225,744	270,098
% CET 1	7.46%	9.86%	7.13%	10.81%
% Tier 1	7.61%	9.98%	7.28%	10.94%
% CRAR	10.50%	12.73%	10.25%	13.77%
% Net interest margin	1.87%	2.19%	2.34%	2.03%
% PAT / ATA	-2.43%	0.02%	-0.69%	0.17%
% Return on net worth	-50.94%	0.39%	-15.46%	2.58%
% Gross NPAs	17.63%	12.66%	17.89%	12.56%
% Net NPAs	10.47%	5.93%	10.63%	5.91%
% Provision coverage excl. technical write-offs	45.35%	56.53%	45.44%	56.28%
% Net NPA/ CET	129.9%	65.4%	140.1%	61.1%

Note: Amount in Rs. crore; Net worth and total assets exclude revaluation reserves
Source: OBC, 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)				Rating History for the Past 3 Years								
		Type	Amount Rated	Amount Outstanding	Rating	FY2019				FY2018		FY2017		
					19-Sep-2019	13-Mar-2019	14-Sep-2018	24-May-2018	03-Apr-2018	21-Aug-2017	31-May-2017	12-Jan-2017	05-Sep-2016	24-Jun-2016
1	Basel III Compliant Tier II Bonds Programme	Long Term	3,000.00	3,000.00	[ICRA]A+(hyb) %	[ICRA]A+ (hyb) (Stable)	[ICRA]A+ (hyb) (Negative)	[ICRA]AA- (hyb) (Negative)	[ICRA] AA- (hyb) (Negative)	[ICRA] AA- (hyb) (Negative)	[ICRA] AA- (hyb) (Negative)	[ICRA] AA (hyb) (Negative)	[ICRA] AA (hyb) (Negative)	[ICRA] AA (hyb) (Stable)
2	Basel II Lower Tier II Bonds Programme	Long Term	1,200.00	1,025.00^	[ICRA]A+ %	[ICRA]A+ (Stable)	[ICRA]A+ (Negative)	[ICRA]AA- (Negative)	[ICRA] AA- (Negative)	[ICRA] AA- (Negative)	[ICRA] AA- (Negative)	[ICRA] AA (Negative)	[ICRA] AA (Negative)	[ICRA] AA (Stable)
3	Basel II Upper Tier II Bonds Programme	Long Term	500.00	-	-	[ICRA] A- (Stable); Withdrawn	[ICRA] A- (Negative)	[ICRA] A+ (Negative)	[ICRA] A+ (Negative)	[ICRA] A+ (Negative)	[ICRA] A+ (Negative)	[ICRA] AA- (Negative)	[ICRA] AA- (Negative)	[ICRA]AA- (Stable)
4	Basel III Compliant Tier I Bonds	Long Term	3,000.00	-	-	-	-	-	[ICRA]A (hyb) (Negative); withdrawn	[ICRA]A (hyb); (Negative)	[ICRA]A (hyb); (Negative)	[ICRA]A+ (hyb); (Negative)	[ICRA]A+ (hyb); (Negative)	[ICRA]A+ (hyb); (Negative)
5	Basel II Perpetual Bonds	Long Term	250.00	-	-	-	-	-	-	-	-	[ICRA] AA- (Negative Withdrawn	[ICRA] AA- (Negative)	[ICRA] AA- (Stable)

^ Rs. 175 crore of bonds yet to be issued

% Rating Watch with Positive 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
INE141A08019	Basel III Compliant Tier II Bonds Programme	27-Oct-2014	9.20%	27-Oct-2024	1,000.00	[ICRA]A+ (hyb) %
INE141A08035	Basel III Compliant Tier II Bonds Programme	26-Oct-2015	8.34%	26-Oct-2025	1,000.00	[ICRA]A+ (hyb) %
INE141A08043	Basel III Compliant Tier II Bonds Programme	24-Jun-2016	9.05%	24-Jun-2026	1,000.00	[ICRA]A+ (hyb) %
INE141A09132	Lower Tier II Bonds Programme	30-Nov-2012	8.93%	30-Nov-2022	1,025.00	[ICRA]A+ %
-	Lower Tier II Bonds Programme	Yet to be issued	-	-	175.00	[ICRA]A+ %

% Denotes under rating Watch with Positive Implications

Source: OBC

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