India Ratings Upgrades UCO Bank and its Basel III Tier 2 Bonds to ‘IND AA’; Outlook Stable

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India Ratings and Research (Ind-Ra) has upgraded UCO Bank’s Long-term Issuer Rating and the rating on its Basel III Tier 2 Bonds to ‘IND AA’ from 'IND AA-’. The Outlook is Stable. The detailed rating actions are as follows:

Details of Instruments

Instrument Description	Date of Issuance	Coupon Rate	Maturity Date	Size of Issue (billion)	Rating Assigned along with Outlook/Watch	Rating Action
Long-term Issuer Rating	-	-	-	-	IND AA/Stable	Upgraded
Basel III Tier 2 bonds*	-	-	-	INR 15	IND AA/Stable	Upgraded

* Details in annexure

Analytical Approach

Ind-Ra continues to factor into the ratings the support available from the government of India (GoI). The GoI held a 95.39% stake in UCO at end-June 2024 and the bank is of systemic importance to the government.

Detailed Rationale of the Rating Action

The rating upgrade reflects UCO’s improved capital position and operating buffers, indicating its increasing ability to absorb the impact of expected and unexpected credit costs. The upgrade also reflects the continued improvement in the bank’s asset quality, as reflected by its declining gross non-performing assets (GNPAs) and net non-performing assets (NNPAs), sufficient provision coverage, manageable special mention account 1 (SMA 1) and SMA 2 and structural changes in underwriting practices. These factors, in the agency’s opinion, could help sustain UCO’s improved profitability in the medium term and maintain its market share in advances & deposits.

List of Key Rating Drivers

Strengths

- Strengthened and better-than-peers’ capital buffers
- Continued improvement in asset quality
- Improvement in quality of earnings led by declining credit costs
- Structural changes in the past to support consistency in performance

Weaknesses

- Weaker-than-peers liability franchise

Detailed Description of Key Rating Drivers

Strengthened and Better-than-peers’ Capital Buffers: UCO’s common equity tier 1 (CET1) ratio continued to improve and was 14.36% in 1QFY25 (FY24: 14.14%; FY23: 13.51%; FY22: 10.97%), despite the absence of any equity infusion, supported by improving internal accruals. Also, the bank carried deferred tax assets of INR73 billion at FYE24

(FY23: INR82 billion; FY22: INR92 billion), which were reduced from the net worth to arrive at CET1. As the utilisation of deferred tax assets continues, it will reduce the drag on CET 1. UCO has received regular equity infusions from the GoI (FY21: INR26 billion; FY16-FY20: INR200.45 billion), which has helped the bank to do a sharp catch-up on the provision coverage ratio over FY18-FY23. Thus, the need to provide for legacy NPAs has been taken care of, thereby reducing the pressure on profitability. Over the medium term, with the bank's returning to profitability, Ind-Ra expects its internal accruals to help maintain the capital buffers at an annual growth rate of 12%-15%.

Continued Improvement in Asset Quality: UCO's gross NPA and net NPA continuously improved to 3.3% in 1QFY25 (FY24: 3.5%; FY23: 4.78%, FY22: 7.89%) and 0.78% (0.89%; 1.29%, 2.7%). Also, it maintained adequate provision coverage ratio (excluding technical write-offs) of 77% in 1QFY25 (FY24: 74.9%; FY23: 73.9%; FY22: 67.6%). The improved asset quality is supported by a substantial decline in slippages to 1.03% in 1QFY25 (FY24: 1.1%, FY23: 1.75%, FY22: 5.72%) broadly in line with peers. Also, the write-offs taken by the bank declined to INR3 billion in 1QFY25 (FY24: INR19.4 billion; FY23: INR25.7 billion; FY22: INR38.5 billion; FY22: INR94.1 billion). Ind-Ra expects the bank to maintain comfortable asset quality over the medium term, given adequate provisioning on the slipped assets. Also, additional stress from the outstanding standard restructured assets or SMA pool (1.57%) is expected to be manageable for the bank over the medium term.

Improvement in Quality of Earnings, Led by Declining Credit Costs: UCO improved its net income to INR5.5 billion in 1QFY25 (FY24: INR16.5 billion, FY23: INR18.62 billion, FY22: INR9.30 billion, FY21: INR1.67 billion) after reporting cumulative losses of INR158.45 billion over FY16-FY20. UCO's net interest margins were rangebound at 3.09% in 1QFY25 (FY24: 2.92%, FY23: 2.87%, FY22: 2.73%), supporting its operating income. While its elevated cost-to-income ratio of 57.2% in 1QFY25 (FY24: 59.7%, FY23: 55.94%, FY22: 49.89%) largely led to a decline in the pre- provision operating profit margins (PPOP to average assets) to 1.47% in FY24 and 1.53% in FY23 with a slight improvement to 1.61% in 1QFY25, the contribution of recoveries from written-off accounts continued to support its PPOP performance over FY23-1QFY25. A substantial decline in credit costs to 0.9% in 1QFY25 (FY24: 0.66%, FY23: 1.0%, FY22: 2.6%, FY21: 5.2%; FY20: 8.5%) including additional provisions provided in FY24 for ECL implementation provides further comfort. Barring any major credit events such as COVID-19, Ind-Ra expects the bank to maintain adequate profitability over the medium term with return on assets of 0.6%-0.8%. Furthermore, the management aims to achieve mid-teens return on equity on a sustainable basis which should provide a runway for advances growth in the near to medium term.

Structural Changes in the Past to Support Consistency in Performance: UCO's advances mix has changed over the past few years, with the share of corporates reducing to around 40% in FY24 (FY16: 60%). Also, the rating profile of the corporate advance mix has improved with the share of the A & above ratings in the overall mix increasing to 74% from 57% in FY21. Furthermore, the bank has centralised their credit underwritings from the earlier branch-level underwriting. These structural changes in the bank over the past five years could help sustain the consistency in its operating performance.

Weaker-than-peers Liability Franchise: UCO's current account savings account ratio stood at 36.7% in 1QFY25 (FY24: 37.28%, FY23: 36.79%, FY22: 39.42%; FY21: 38.81%) and remained lower than its similar-rated peers. While the bank is taking measures to enhance its current account savings account franchise, material improvement is yet to be seen. Management is cognizant of the loss in market share over the past few years. Thus, with the objective of streamlining the business, it is aiming for a materially higher market share in both deposit and advances than peers in the medium term.

UCO continues to face high competition in mobilisation of deposits in line with other banks, with loan growth of 14% and deposit growth of 5% in FY24. While the bank's loan to deposit ratio is increasing (1QFY25: 72.07%; FY24: 71.02%, FY23: 64.82%, FY22: 54.91%), it remains comfortable. Ind-Ra expects the bank to maintain loan to deposit ratio between 75%-80% in the medium term. The bank's ability to maintain the loan growth, amid the continued competition for mobilisation of deposits, remains a key near- to medium-term monitorable.

Liquidity

Adequate: As of June 2024, UCO's short-term (one year) asset liability mismatches (cumulative funding deficit) stood at 21.0% of total assets; however, this can be adequately covered by the bank as it had excess statutory liquidity ratio of INR197 billion by end-1Q (7.4%). The liquidity coverage ratio was 131% as on 30 June 2024, well above the regulatory requirement of 100%. If its deposit growth continues to lag with the advance growth, then the bank may need to increasingly rely on wholesale sources, affecting its liquidity. However, it seems manageable in the foreseeable future.

Rating Sensitivities

Positive: Substantial, demonstrated growth in franchise delivering consistent market share gains, a further improvement in the profitability while maintaining the capital buffers at materially higher levels than the regulatory requirements and an improvement in deposit profile hereon could result in a positive rating action.

Negative: The Basel III Tier-2 bond rating are based on Ind-Ra's expectation of continuous support from the GoI (majority shareholder) to meet the minimum capital requirements. Any change in the majority GoI ownership or a change in the agency's opinion regarding the GoI's timely support for the bank, which could be warranted in case of a sharp drop in the capitalisation or otherwise, could result in a negative rating action or a rating watch. Also, sharp deterioration in the operating performance and consistent pressure on the asset quality could lead to a negative rating action.

ESG Issues

ESG Factors Minimally Relevant to Rating: Unless otherwise disclosed in this section, the ESG issues are credit neutral or have only a minimal credit impact on UCO, due to either their nature or the way in which they are being managed by the entity. For more information on Ind-Ra's ESG Relevance Disclosures, please click here. For answers to frequently asked questions regarding ESG Relevance Disclosures and their impact on ratings, please click here.

About the Company

UCO is a public sector bank, with operations across India. At end-June 2024, the bank had over 3,230 branches, with a strong presence in eastern India. The bank has two overseas branches, one each in Hongkong and Singapore and a representative office in Iran.

Key Financial Indicators

Particulars	FY24	FY23
Total assets (INR billion)	3,236.91	3,008.63
Total equity (INR billion)	273.57	257.65
Net income/loss (INR billion)	16.55	18.62
Return on average assets (%)	0.53	0.66
CET I (%)	14.1	13.51
Capital adequacy ratio (%)	17.0	16.51
Source: UCO; Ind-Ra		

Status of Non-Cooperation with previous rating agency

Not applicable

Rating History

Instrument Type	Rating Type	Rated Limits (billion)	Current Ratings	Historical Rating/Outlook			
				15 December 2023	16 December 2022	17 December 2021	5 August 2021
Issuer Rating	Long-term	-	IND AA/Stable	IND AA-/Positive	IND AA-/Stable	IND AA-/Stable	IND AA-/Negative
Basel III Tier II bonds	Long-term	INR15	IND AA/Stable	IND AA-/Positive	IND AA-/Stable	IND AA-/Stable	IND AA-/Negative

Complexity Level of the Instruments

Instrument Type	Complexity Indicator
Basel III Tier 2 bonds	Medium

For details on the complexity level of the instruments, please visit https://www.indiaratings.co.in/complexity- indicators.

Annexure

Issue Name/Type	ISIN	Date of Issuance	Coupon Rate (% p.a.)	Maturity Date	Size of Issue (billion)	Rating/Outlook
Basel III Tier II bonds	INE691A08054	28 June 2019	9.64	28 June 2029	INR5	IND AA/Stable
Basel III Tier II bonds	INE691A08062	16 December 2019	9.71	16 December 2029	INR5	IND AA/Stable
Basel III Tier II bonds	INE691A08070	22 March 2022	8.51	22 March 2032	INR4	IND AA/Stable
Basel III Tier II bonds	INE691A08088	31 March 2022	8.51	31 March 2032	INR1	IND AA/Stable
	Total utilised limit				INR15	
Source: NSDL; UCO						

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Rating Bank Subordinated and Hybrid Securities

Evaluating Corporate Governance

Financial Institutions Rating Criteria

The Rating Process