India Ratings Revises Outlook on UCO Bank and its Basel III Tier 2 Bonds to Positive; Affirms 'IND AA-'

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India Ratings and Research (Ind-Ra) has revised UCO Bank's Outlook to Positive from Stable while affirming the Long-term Issuer Rating at 'IND AA-'. The instrument-wise rating action is as follows:

Instrument Type	Date of Issuance	Coupon Rate (%)	Maturity Date	Size of Issue (billion)	Rating/Outlook	Rating Action
Basel III Tier 2 bonds*	-	-	-	INR15	IND AA-/Positive	Affirmed; Outlook Revised to Positive

*Details in annexure

Analytical Approach: Ind-Ra continues to factor in the support from the government of India (GoI) to arrive at the ratings. The GoI held a 95.39% stake in UCO at end-September 2023 and the bank is of systemic importance to the government.

The Outlook revision reflects the bank's improving capital position and operating buffers, indicating its increasing ability to maintain its market share and absorb the impact of expected and unexpected credit costs. The Positive Outlook also reflects the drastic reduction of adverse provisioning impact of legacy non-performing assets (NPAs) on UCO and overall improvement in the lending environment especially for banks. These factors, in the agency's opinion, could boost UCO's profitability in the medium term on a sustainable basis and help grow its share in advances and deposits over the medium term.

Key Rating Drivers

Strengthened Capital Buffers: UCO's CET1 ratio improved to 13.51% in FY23 (FY22: 10.97%, FY21: 11.14%), despite absence of any equity infusion; supported by strong internal accruals. The CET 1 ratio stood at 13.74% in 1HFY24 which does not include the year-to-date profitability for 1H. UCO had received regular equity infusions from the GoI (FY21: INR26 billion; FY16-FY20:INR200.45 billion), which helped the bank to do the the sharp catch-up in the provisions coverage ratio over FY18-FY23. Thus, the need to provide for legacy non-performing assets (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 14%-15%.

Continued Improvement in Asset Quality: UCO's gross NPA and net NPA continuously improved to 4.14% in 1HFY24 (FY23: 4.78%, FY22: 7.89%, FY21: 9.59%) and 1.11% (FY23: 1.29%, FY22: 2.7% , FY21: 3.94%). The bank maintained adequate provision coverage ratio (excluding technical write-offs) of 75% in 1HFY24. The improved asset quality is supported by a substantial decline in slippages to 1.42% in 1HFY24 (FY23: 1.75%, March 2022: 5.72%). The improvement is broadly in line with other peers. Also, the write-offs taken by the bank declined to INR13 billion in 1HFY24 (FY23: INR25.7 billion; FY22: INR38.5 billion; FY22: INR94.1 billion). The agency expects the bank to maintain comfortable asset quality over the medium term, given adequate provisioning on the slipped assets. The additional stress from outstanding standard restructured assets (around 2.5%), Emergency Credit Line Guarantee Scheme loans or special mention accounts 1&2 pool (around 5%) is expected to be manageable for the bank over the medium term.

Liquidity Indicator – Adequate: As of September 2023, UCO's short-term (one year) asset liability mismatches (cumulative funding deficit) stood at 11.0% of total assets; however, this can be adequately covered by the bank as it had excess statutory liquidity ratio of INR235 billion as of September 2023. The liquidity coverage ratio was 179% in FY23 (FY21: 229.9%), well above the regulatory requirement. As of 1HFY24, the bank maintained around 12% of its total assets in balances with the Reserve Bank of India and in government securities. If its deposit growth does not keep pace 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.

Improvement in Quality of Earnings Led by Declining Credit Costs: UCO's reported net income improved to INR6.25 billion in 1HFY24 (FY23: INR18.62 billion, FY22: INR9.30 billion, FY21: INR1.67 billion) after cumulative losses of INR158.45 billion over FY16-FY20. UCO's net interest income grew 13.4% yoy and 14.8% yoy in FY23 and 1HFY24 respectively, while the net interest margins were rangebound at 3% in 1HFY24 (FY23: 2.87%, FY22: 2.81%), supporting its operating income. While its elevated cost-to-income ratio of 58.04% in 1HFY24 (FY23: 55.94%, FY22: 49.89%) largely led to a slight decline in the pre- provision operating profit margins (PPOP to average assets) to 1.4% (1.5%, 1.8%), the contribution of recoveries from written-off accounts continued to support its PPOP performance over FY23-1HFY24. A substantial decline in credit costs to 1.5% (annualised; including additional provisions of INR2 billion for ECL) in 1HFY24 (FY23: 1.0%, FY22: 2.6%, FY21: 5.2%FY20: 8.5%) led to a strong boost in profit generation. 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.

Ind-Ra does not expect a material loss from the recent IT related issue which led to erroneous credits through IMPS to UCO's certain account holders. However, the bank needs to continuously invest in its IT infrastructure and strengthen the cyber risk measures to avoid such incidents in the future.

Weaker-than-peers Liability Franchise: UCO's current account savings account ratio at 37.62% in 1HFY24 (FY23: 36.79%, FY22: 39.42%; FY21: 38.78%) remained lower than its similar-rated peers. While the bank is taking measures to enhance its current account savings account franchise, the 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.

With the likely higher loan growth in the medium term, any deterioration in the liability profile deteriorates remains to be seen. The challenges get accentuated, given public sector banks in general (including UCO) have not opened many new branches and most banks now have the appetite to lend, leading to increased competition among banks for mobilising deposits.

Rating Sensitivities

Positive: Sustained systemic importance reflected in the bank's improving market share in advances and deposits could lead to a positive rating action. A consistent improvement in the bank's standalone capital and profitability buffers (with increased profitability from the core lending operations), while maintaining peer-comparable asset quality or better, and an overall improvement in the operating environment could also lead to 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, sustained 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.

Company Profile

UCO is a public sector bank, with operations across India. At end-September 2023, the bank had over 3,200 branches, with a strong presence in eastern India.

FINANCIAL SUMMARY

Particulars	FY23	FY22
Total assets (INR billion)	3,008.63	2,677.84
Total equity (INR billion)	257.65	235.94

Net income/loss (INR billion)	18.62	9.30
Return on average assets (%)	0.66	0.36
CET I (%)	13.51	10.97
Capital adequacy ratio (%)	16.51	13.74
Source: UCO; Ind-Ra		

Non-Cooperation with previous rating agency

Not applicable

Solicitation Disclosures

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Rating History

Instrument Type	Current Rating/Outlook				
	Rating Type	Rated Limits (billion)	Rating	16 December 2022	D
Issuer rating	Long-term	-	IND AA-/Positive	INDAA-/Stable	

Basel III Tier II bonds	Long-term	INR15	IND AA-/Positive	INDAA-/Stable

Annexure

Issue Name/Type	ISIN	Date of Issuance	Coupon Rate (% p.a.)	Maturity Date	Size of Issue (billion)	Rating/Ou
Basel III Tier II bonds	INE691A08054	June2019	9.64	June 2029	INR5	IND AA-/Posi
Basel III Tier II bonds	INE691A08062	December 2019	9.71	December 2029	INR5	IND AA-/Posi
Basel III Tier II bonds	INE691A08070	March 2022	8.51	March 2032	INR4	IND AA-/Posi
Basel III Tier II bonds	INE691A08088	March 2022	8.51	March 2032	INR1	IND AA-/Posi
	Total utilised limit				INR15	

Complexity Level of Instruments

Instrument Type	Complexity Indicator
Basel III tier 2 bonds	Moderate

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

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Financial Institutions Rating Criteria

Evaluating Corporate Governance

The Rating Process

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