CREDIT RATING REPORT

Indian Overseas Bank

September 2008

INSTRUMENTS RATED	RATINGS
Rs.7 Billion Upper Tier II Bond Issue	**AA+/Stable**
Rs.3 Billion Lower Tier II Bond Issue	**AA+/Stable**
Rs.5 Billion Upper Tier II Bond Issue	**AA+/Stable**
Tier I Perpetual Bond Issue Aggregating Rs.6 Billion	**AA+/Stable**
Lower Tier II Bond Issue Aggregating Rs.15 Billion	**AA+/Stable**
Certificates of Deposit Programme	**P1+**

RATING HISTORY

Date	Long-Term	Fixed Deposit	Short-Term	Rating Watch/Outlook
September 06, 2004	AA+	-	P1+	Stable
October 28, 2003	AA	-	P1+	Stable

Rating Drivers

Strengths

- Healthy earnings profile, driven by Indian Overseas Bank's (IOB's) focus on lending to high-yield customers
- Comfortable resource profile
- Adequate capitalisation levels
- Expected support from majority owner, the Government of India (GoI)

Weaknesses

- Moderate asset quality because of exposure to mid-sized corporates
- Operations concentrated in South India

Rating sensitivity factors

- Extent of GoI's shareholding and support
- Underlying asset quality
- Earnings profile and capitalisation levels

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CRISIL Complexity Levels are assigned to various types of financial instruments. The CRISIL Complexity Levels for the instruments featured in this document are available on www.crisil.com/complexity-levels. Investors are advised to refer to the CRISIL Complexity Levels for instruments that they propose to invest in. Investors can also call the CRISIL Helpline at +91 22 6691 3047 / + 91 22 66913064 with queries on specific instruments.

In addition to the above, the ratings on IOB's Tier I perpetual bonds and Upper Tier II bonds remain sensitive to:

- Weakening in earnings profile
- Ability to maintain comfortable capital adequacy levels
- Aggressive credit growth
- Reserve Bank of India's (RBI's) stance, should the bank report losses

Outlook: Stable

CRISIL believes that IOB will continue to benefit from GoI's support. The bank's healthy earnings, comfortable resource profile, and adequate capitalisation, will continue to provide stability to its standalone credit risk profile over the medium term. The outlook could be revised to 'Positive' if there is significant improvement in the bank's capitalisation or asset quality levels. Conversely, deterioration in the bank's earnings or resource profiles could cause the outlook to be revised to 'Negative'.

Note on Hybrid Instruments

CRISIL rates hybrid instruments on the same rating scale as conventional long-term debt instruments (including lower Tier II bonds). However, as hybrid capital instruments have characteristics that set them apart from lower Tier II bonds, the ratings on the two may not necessarily be identical.

CRISIL's ratings on the debt instruments reflect the likelihood of timely payment of interest and principal on these instruments. CRISIL defines default as failure to make timely payment of interest and principal; in the case of conventional debt instruments, a default event may result from factors such as the issuer's losses or lack of liquidity. For hybrid capital instruments, there are other factors that could trigger a default event; these include the bank's breaching the regulatory minimum capital requirement, or the regulator's denial of permission to the bank to make payments of interest and principal if the bank reports a loss. In the case of hybrid capital instruments, transition from one rating category to another may be significantly sharper than with other debt instruments; this is because debt servicing on hybrid instruments is far more sensitive to the bank's overall capital adequacy levels and profitability.

Rationale

IOB was established in 1937, in Chennai, and was nationalised in 1969. It had 1847 branches and 51 extension counters as on March 31, 2008. It also has six overseas branches, two in Hong Kong and one each in Singapore, South Korea, Sri Lanka, and Thailand.

In September 2000, GoI diluted its holding in the bank to 75 per cent from 100 per cent by way of a public issue of shares at par, amounting to Rs.1.1 billion. In 1994, IOB was recapitalised by GoI, which helped it to absorb significant accumulated losses on its balance sheet. IOB concluded a successful second public offering of 100 million shares at Rs.24 each (Rs.14 premium per share) and augmented its Tier 1 capital by Rs.2.4 billion in September 2003.

The ratings on the bank are primarily driven by:

IOB's profitability expected to be superior to the Indian banking industry average, driven by high-yield advances

- **Healthy earnings profile, driven by IOB's focus on lending to high-yield customers**
  The rating on IOB derives significant support from the bank's strong earnings profile, marked by a high yield on its advances portfolio. The bank's net profitability margin (NPM[1]) in 2007-08 (refers to financial year, April 1 to March 31) was strong at 1.8 per cent and was significantly higher than the estimated industry average of 1.4 per cent. However, the NPM was less than in 2006-07, because of the fall in interest spread due to high borrowing costs in 2007-08. Nevertheless, the decline in interest spread was partially offset by the improvement in operating expenses ratio during the year. IOB's core fee income continued to be modest at 0.9 per cent in 2007-08 as compared with 0.8 per cent in 2006-07. Further, its return on assets (RoA), at 1.3 per cent in 2007-08, as against 1.4 per cent in 2006-07, is significantly more than the industry average.

  IOB has a strong profitability, largely because of its high interest spreads; for 2007-08, it is estimated at ,2.7 per cent and is driven largely the bank's focus on lending to high-yield customers, such as traders, who belong to the middle and lower end of the credit spectrum.

  CRISIL believes that IOB's earnings profile will continue to be better than the banking industry over the medium term, driven by high-yield advances and moderate core fee-based incomes. IOB's interest spread, provisioning costs, and operating efficiencies, will also play a critical role in maintaining the profitability. The operating expense ratio could increase marginally because of enhanced provisioning requirements towards retirement benefits of its employees, in accordance with the revised Accounting Standard -15, and increase in salaries.

Large deposit base and comfortable proportion of CASA deposits lend stability to IOB's resource profile

- **Comfortable resource profile**
  IOB has a comfortable resource profile, marked by a large deposit base and moderate proportion of low-cost deposits. As on June 30, 2008, IOB had a deposit base of Rs.850 billion; low-cost current and savings account (CASA) deposits accounted for 30.6 per cent of total deposits. IOB's healthy proportion of CASA deposits was owing to the bank's strong presence in rural and semi-urban areas; 56 per cent of IOB's total branches are located in rural and semi-urban areas and deposits from these areas is estimated to account for around 30 per cent of the bank's total deposits. These factors provide stability to IOB's resource profile. However, the increase in competition in the industry to mobilise retail deposits in the past year resulted in higher cost of deposits for IOB; IOB's costs of deposits for 2007-08 is estimated at 6.7 per cent (5.1 per cent in 2006-07), which is expected to be marginally higher than the industry average.

  CRISIL believes that maintaining a healthy proportion of low-cost CASA deposits will be a key monitorable for the bank to control its overall cost of borrowings and ensure healthy NPM for the bank. IOB, with its large deposit base and strong

[1] CRISIL uses Net Profitability Margin as its measure of core profitability. NPM is defined as (Yield on funds deployed) – (Average borrowing costs) – (Operating expense ratio) + (Fee income levels). This has been calculated based on fortnightly average numbers.

presence in rural and semi-urban areas, will continue to have a comfortable resource profile over the medium term.

IOB will maintain its adequate capitalisation levels, driven by comfortable profitability

- **Adequate capitalisation levels**
  IOB will continue to post comfortable accretions to net worth, driven by a healthy profitability, which will ensure that the bank is able to maintain adequate capitalisation levels over the medium term. IOB's Tier I capital adequacy ratio stood at a moderate 7.3 per cent (as per Basel II) as on March 31, 2008. Its absolute Tier I capital stood at Rs.52 billion as on March 31, 2008. The management's stated posture that it will maintain the bank's Tier I ratio at around 7 per cent and the overall capital adequacy ratio at 11 per cent provides comfort with respect to its capital position. Further, GoI's holding at 61.23 per cent provides adequate flexibility to the bank to raise additional equity through dilution of GoI stake to regulatory minimum of 51 per cent to meet any asset-side risks.

Support of GoI is underpinned by the policy role played by the banking system, and the serious implications of defaults by PSBs on Indian economy and political system

- **Expected support from majority owner, GoI**
  An important factor that supports the ratings on several Indian public sector banks (PSBs) is the systemic support they are expected to receive in the event of distress. PSBs play a dominant role in India's economy, given that they account for over 70 per cent of the deposits and advances in the commercial banking sector. In the past, GoI has supported PSBs by infusing about Rs.225 billion on their recapitalisation; most PSBs have benefited from the same. As banks continue to grow in an increasingly sophisticated financial market, events of distress are likely to occur; the expectation of GoI support to PSBs in such a scenario is, therefore, a key driver of PSB ratings. CRISIL believes that this support from GoI is underpinned by the policy role played by the banking system, and the serious implications of default by PSBs on the Indian economy and political system. As per extant regulations, GoI is required to maintain a minimum stake of 51 per cent in PSBs. Given its majority ownership of PSBs, GoI has a moral obligation to support the banks if the need arises.

The abovementioned rating strengths are partially offset by:

- **Moderate asset quality because of exposure to mid-sized corporates**
  IOB has demonstrated a declining trend in gross non-performing asset (NPA) levels and an improved provisioning cover. IOB's asset quality, however, is inherently average, marked by significant exposure to clients with moderate credit quality.

  The bank has sought to arrest additions to gross NPAs by stepping up its recovery efforts, during the past three years. Gross NPAs declined to 1.6 per cent as on March 31, 2008, from 10.3 per cent as at March 31, 2003. A combination of recoveries and substantial write-offs during the past 5 years contributed to a substantial reduction in overall NPAs. However, the gross and net NPAs will be high if restructured accounts are taken into consideration.

  The credit profile of IOB's borrowers, on an overall basis, compares less favourably vis-à-vis peer banks. CRISIL believes that IOB's asset quality will remain average, as the major target segments among borrowers consist of mid-sized corporate clients and traders. CRISIL further believes that IOB's asset quality could be constrained over the next 1 to 2 years due to vulnerability of its target segment to any slowdown in the economy and the high concentration to specific sectors and would be required to make higher provisioning to maintain its asset quality.

Significant business concentration in South India exposes IOB to concentration risks

- **Operations concentrated in South India**
  IOB's business is by-and-large concentrated in southern India; about half of its branches, deposits, and advances, are concentrated in this region. IOB intends to expand to new geographical areas over the medium term in order to improve its market position and reduce its geographical concentration. CRISIL, nevertheless, believes that IOB's business profile will remain significantly vulnerable to geographic concentration risks over the medium term.

Industry Prospects

The Indian banking system witnessed high growth, with advances registering a compounded annual growth rate (CAGR) of 30 per cent over the past three years. The strong growth was primarily due to consistent demand from the corporate and retail finance segments. However, rising interest rates and RBI's monetary and credit measures restricted the growth to 20 to 25 per cent levels in 2007-08.

The key challenge for the banking industry will be to raise resources at competitive rates. The banking system's funding costs have increased by 50 to 60 bps in 2007-08, owing to the impact of rising interest rates and increasing dependence on high-cost deposits of a shorter maturity. During 2007-08, banks were able to partially pass on the rise in interest costs by increasing lending rates; this, coupled with reduced operating expenses, resulted in an improvement in core profitability. The net NPM for the banking industry for 2006-07 was an estimated 1.6 per cent. However, CRISIL expects that the scramble to keep pace with credit growth at 20 to 25 per cent levels has pushed up funding costs for banks by 50 bps in 2007-08. This, along with the recent regulatory measures, such as higher reserve requirements and increase in benchmark interest rates, is likely to dent the banking system's profitability by around 20 bps.

Sustained improvement in the inherent credit quality across corporate borrowers, and granularity provided by the retail loan segment have helped banks improve their assets quality levels significantly; gross NPAs for the industry as on March 31, 2008, are estimated at 2.5 per cent. However, CRISIL believes that the banking system's NPA levels have reached their possible lows. In CRISIL's opinion, the asset-side risks are negligible, given that Indian banks are adequately capitalised and well placed in terms of coverage for weak assets. RBI has released the final guidelines for capital adequacy under Basel II and the incremental capital requirements for the banking sector are manageable; taking into account both credit risk and operational risk, CRISIL estimates the net capital saving to be around 10 bps for the industry when the guidelines are implemented.

Business Profile

Market position

IOB is a large bank, with an asset base of Rs.1017 billion and a large network of 1847 branches as on March 31, 2008. IOB has an estimated market share of 2.8 per cent in deposits and 2.7 per cent in advances. In 2007-08, growth in IOB's deposits and advances was 23 per cent and 28 per cent respectively. In terms of business, deposits and advances are concentrated in South India, with the region accounting for about half of its branches, deposits, and advances as on March 31, 2008.

IOB mainly caters to the mid-size corporate segments and small businesses, which typically provide higher yields. Retail loan portfolio constitutes about 13 per cent of total advances and is estimated to remain at this level in the near term.

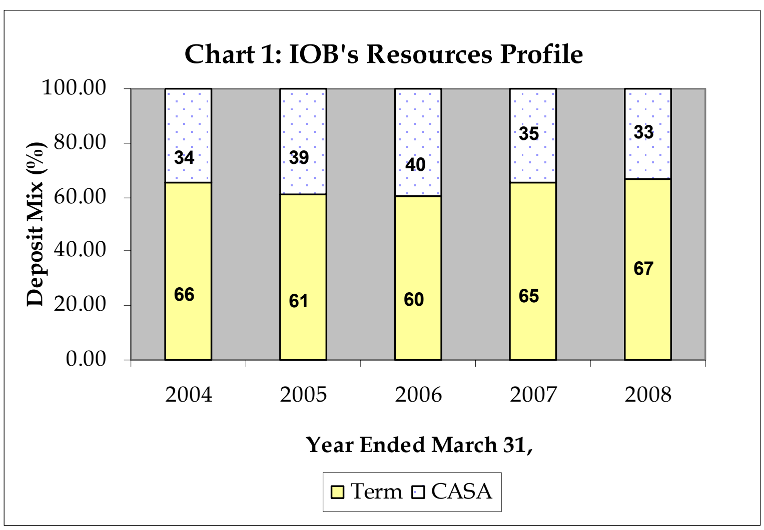
Asset quality

The bank's gross and net NPAs have consistently declined over the 3 years, in line with industry trend, and stood at 1.6 per cent and 0.6 per cent respectively as on March 31, 2008. Improvement in gross NPA ratio was driven by high levels of write-offs in the past 5 years and the bank's increasing focus on recovery. Slippages (additions to NPAs/opening advances) declined to 1.4 per cent in 2007-08 from 2.0 per cent in the previous year. Standard assets restructured during 2007-08 have increased to Rs.6.5 billion from Rs.5.3 billion in 2006-07.

Resources

As on March 31, 2008, IOB had a large deposit base of Rs.843.3 billion. Deposits grew at a 3-year CAGR of 24 per cent. CASA deposits accounted for 33.5 per cent of the total deposit base as on March 31, 2008 (*see Chart 1*), which is comparable to the industry average. However, CASA deposits have declined to 30.6 per cent as of June 30, 2008.

IOB's cost of deposits is estimated at 6.7 per cent in 2007-08, as compared with 5.1 per cent in the previous year. As a significant proportion of IOB's deposits are retail in nature, this provides stability to the bank's resource profile.

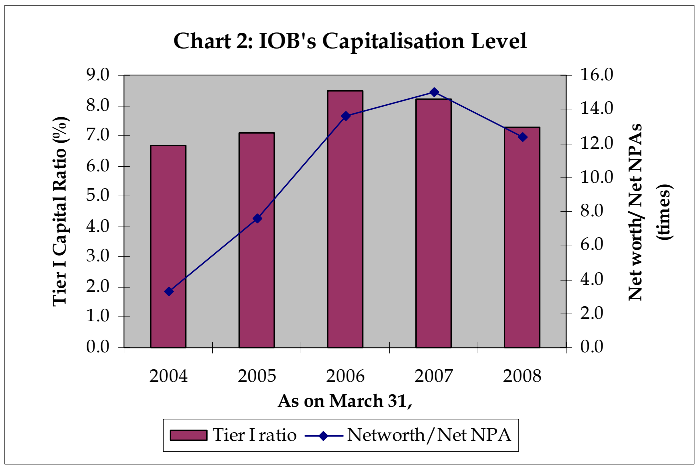


Financial Profile

Capital adequacy

IOB's Tier I capital ratio stood at 7.3 per cent as on March 31, 2008 (as per Basel II) as compared with 8.2 per cent as on March 31, 2007 (as per Basel I; *see Chart 2*). The bank's absolute Tier I capital is healthy at an estimated Rs.52 billion (Rs.43 billion as on March 31, 2007). Overall capital adequacy ratio (CAR) as on March 31, 2008, was 11.6 per cent – as per Basel II (13.3 per cent as on March 31, 2007 – as per Basel I).

As on March 31, 2008, the bank coverage of net NPAs, as reflected by net worth to net NPAs ratio, was high at 13 times, which declined to around 10 times as on June 30, 2008. The quality of Tier I capital has improved as hybrid Tier I bonds constitute 9 per cent of total Tier I capital due to healthy accruals to net worth. The banks return on average assets has declined to 1.3 per cent in 2007-08 from 1.4 per cent in 2006-07.



Earnings

IOB's profitability is driven by its focus on the mid-sized corporates and small business segments, which typically provides higher yields. IOB's NPM was 1.8 per cent in 2007-08 and has declined from 2.2 per cent in 2006-07 on account of higher borrowing costs. Yields on funds deployed have been in the range of 8.8 to 9.5 per cent in the past 5 years, while borrowing costs had steadily declined from 6.4 per cent in 2002-03 to 5.0 per cent in 2005-06, though they have gone up significantly in 2007-08.

The diversity of IOB's earnings profile is moderate, with fee income constituting 0.9 per cent of funds deployed. Operating expense ratio, which was traditionally higher than industry average, is estimated to have declined to about 1.8 per cent in 2007-08 from 2.1 per cent in 2006-07. The improvement in operating expense ratio is on account of IOB managing to control its expenses and achieving operating efficiencies.

The bank's profit after tax (PAT) increased by 19 per cent in 2007-08 (29 per cent in 2006-07) primarily due to 35.5 per cent rise in other income. In 2007-08, IOB reported a profit after tax (PAT) of Rs.12 billion on a total income (net of interest expense) of Rs.34.9 billion, as compared with a PAT and a total income of Rs.10.1 billion and Rs.29.5 billion respectively in 2006-07.

IOB's PAT declined marginally in the quarter ending June 30, 2008, to Rs.2.6 billion on a total income (net of interest expense) of Rs.7.3 billion, as compared with a PAT and total income of Rs.2.7 billion and Rs.7.1 billion respectively in the corresponding period of the previous year. The decline in PAT was due to negative income of Rs.0.3 billion during the quarter ended June 30, 2008, resulting from loss on inter-segment transfer of securities in the investment portfolio and loss on sale of investments during the quarter.

Liquidity and asset-liability management

The bank had strong liquidity, marked by excess statutory liquidity ratio (SLR) of around Rs.25 billion and a good proportion of stable savings deposits at around 23 per cent, as on March 31, 2008. Given IOB's high proportion of retail deposits (demand, savings as well as term deposits), the bank's asset-liability management profile is sound with manageable negative mismatches in the short-term tenure maturity buckets.

IOB's liquidity position benefits from access to systemic sources of funds, such as liquidity adjustment facility from RBI, access to call money market and refinance limits enjoyed from sources such as National Housing Bank and NABARD.

Key Financials

As on / For the year ended March 31		2008	2007	2006	2005
Deposits	Rs Bn.	843.3	687.4	505.3	442.4
Advances	Rs Bn.	604.2	470.6	347.6	252.1
Equity capital	Rs Bn.	5.4	5.4	5.4	5.4
Net worth	Rs Bn.	47.4	38.7	30.5	24.3
Assets Deployed	Rs Bn.	1017.4	821.4	592.4	506.7
Total Income (net of interest expenses)	Rs Bn.	34.9	29.5	27.9	26.5
Profit on sale of investments	Rs Bn.	2.3	2.4	2.8	3.9
Other Income (excl. profit on sale of investments)	Rs Bn.	8.4	6.2	2.6	4.2
Operating Expenses	Rs Bn.	14.1	13.9	12.6	11.6
Reported PAT	Rs Bn.	12.0	10.1	7.8	6.51
Ratios					
Net Interest Income / Avg. Total Assets	per cent	2.9	3.6	3.8	3.8
Non Int. income/Avg. total assets	per cent	0.9	0.5	1.3	1.6
Non Int. Expenses/Avg. total assets	per cent	1.6	2.0	2.3	2.4
Return on Average Assets	per cent	1.3	1.4	1.4	1.3
Return on Average Net worth	per cent	27.9	29.1	28.0	29.9
Tier I Capital Adequacy Ratio	per cent	7.3 *	8.2	8.5	7.1
Gross NPAs / Gross Advances	per cent	1.6	2.3	3.4	5.3
Net NPAs / Net Advances	per cent	0.6	0.6	0.7	1.3

* As per Basel II

Key Financials for the quarter ended June 30, 2008

Particulars/ Quarter ended		**June-08**	**June-07**
Net Interest Income	Rs Billion	7.3	7.1
Non-Interest Income	Rs Billion	(0.3)	0.6
Total Income (net of interest expenses)	Rs Billion	7	7.7
Operating Expenses	Rs Billion	4.5	3.6
Operating Profit	Rs Billion	2.4	4.1
Provisions	Rs Billion	-0.6	0.6
Profit Before Tax	Rs Billion	3.0	3.5
Profit after Tax	Rs Billion	2.6	2.7
Gross NPAs / Gross Advances	%	1.7	2.3
Net NPAs / Net Advances	%	0.8	0.5
Overall Capital Adequacy Ratio	%	11.25 *	13.3

* As per Basel II

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