Fitch Rating has downgraded the Viability Rating (VR) of public sector lender Punjab National Bank from “bb-" to “b” and maintained it on Rating Watch Negative (RWN).

The two-notch downgrade to PNB's VR is a reflection of the significant deterioration in its standalone credit profile, mainly due to a drop in its core capital ratio, which was bigger than Fitch's expectation.

The deterioration in PNB's core capitalisation was caused by a sharp increase in its non-performing loans (NPLs), including the $2.2 billion in fraudulent transactions reported in February 2018, and the related increase in credit costs. It resulted in large losses in the financial year ended March 2018 (FY18), Fitch said in a statement today.

The decline also highlights the management's weaker execution and previous underwriting and oversight gaps, which the bank has already started taking steps to address.

The RWN reflects expectation that the pressures, mainly relating to asset quality, earnings and profitability, will persist at least over the next few quarters. This could weaken PNB's already low core capitalisation further unless the bank is able to save or generate capital through intrinsic sources like non-core asset sales and cost reductions although there is the prospect of the government injecting further capital into the state banks.

At the same time, the agency has affirmed PNB's Long-Term Issuer Default Rating (IDR) at 'BBB-' and its Support Rating Floor and Support Rating at 'BBB-'and '2', respectively. The Outlook on the IDR is Stable. PNB's IDR is at its Support Rating Floor of 'BBB-' and reflects our view of the government’s high propensity to provide extraordinary support to PNB.

An upgrade to PNB's Support Rating Floor and IDR, in the event of a sovereign upgrade, is not likely.

PNB's ability to sustain, if not improve, its buffers through sources such as retained earnings, fresh equity raising and stake sales is important for its VR. Fitch will continue to focus on the bank's ability to raise a significant portion of its capital needs - independent of the government - to counter pressures on its asset quality and earnings performance, failing which further action could be taken on the bank's standalone creditworthiness, it added