February 26, 2021

DCB Bank Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Compliant Tier II Bonds Programme	550.00	550.00	[ICRA]A+(hyb) (Stable); reaffirmed
Short-term Fixed Deposit Programme	-	-	[ICRA]A1+; reaffirmed
Total	**550.00**	**550.00**	

**Instrument details are provided in Annexure-1*

Rationale

The ratings reaffirmation factors in the continued improvement in DCB Bank Limited's liability profile with the increasing share of granular deposits and a corresponding decline in depositor concentration levels. While the capitalisation profile remains comfortable with the Tier I at 14.3% as on December 31, 2020, the monitorable book (overdue loans and standard restructured) remains meaningfully large in relation to the core capital given the steady build-up in the overdue loan portfolio in the higher delinquency buckets because of the Covid-19 pandemic. Nevertheless, ICRA takes note of the bank's granular loan book (typical ticket size of < Rs. 3 crore and an average ticket size of Rs 50-60 lakhs) and its demonstrated track record of maintaining satisfactory collections/recoveries as the overall book remains well collateralised. The extent to which the asset quality will be impacted by the higher delinquencies will remain dependent on DCB Bank's ability to improve the recovery trends in future. The pandemic had a severe impact on the debt servicing ability of the borrowers in the self-employed category, a segment that has been relatively more vulnerable and forms a relatively high proportion of the bank's loan book.

DCB Bank's cost profile remains comparatively weaker, which is reflected by the higher cost of funds and low non-interest income with the same translating into a relatively higher cost-to-income ratio in relation to the private sector banks' (PVB) average. A sustained improvement in the bank's income and cost metrics will remain critical for an improvement in its overall operating profitability. An improvement in the cost metrics will also improve DCB Bank's ability improve the overall return on asset (RoA) levels. However, given the expectation of asset quality pressure in the near term, ability of the bank to improve recoveries/upgrades will drive credit cost and the overall profitability, in absence of which RoA is likely to remain at sub-optimal levels in FY2021 and FY2022.

The Stable outlook on the rating reflects that the bank will be able to reduce its overdue loan book by taking corrective actions and will keep the solvency (net non-performing loans/core capital) level above the negative rating triggers.

Key rating drivers and their description

Credit strengths

Deposit granularity improves with declining share of bulk deposits – DCB Bank's deposit profile continued to witness a sustained improvement over the last two years with a gradual decline in depositor concentration levels. The share of the top 20 depositors reduced to 9.27% of total deposits as on March 31, 2020 and further to 7.28% as on December 31, 2020 from 14.87% as on March 31, 2018. Moreover, the share of bulk deposits (over Rs. 1 crore) in term deposits (including interbank deposits) reduced to ~42% as on September 30, 2020 from ~62% as on June 30, 2018. The bank has continued with its strategy of offering higher interest rates to smaller ticket deposits in the higher maturity buckets (usually 3 years), which has helped granularise the deposit base.

In the past, the growth in net advances was supported by a higher share of bulk deposits. However, as the advances base has been stable (advances degrew by ~1% on a YoY basis to Rs. 25,300 crore as on December 31, 2020), the need to chase bulk deposits reduced and the bank has been able to improve depositor granularity. Moreover, its net advances remain reasonably granular with the share of the granular mortgage, agri and inclusive banking (AIB), and SME/MSME segments constituting 42%, 21%, and 11%, respectively, of net advances as on December 31, 2020, almost similar to the levels as on December 31, 2019. Including other retail products, the share of retail/MSME loans was 89% while that of corporate advances remained limited at 11% as on December 31, 2020 against 85% and 15%, respectively, as on December 31, 2018.

Comfortable capitalisation levels although internal capital generation could weaken next year – The bank's capital ratios remain comfortable with the Tier I and CRAR, as a percentage of risk-weighted assets (RWAs), at 14.3%[1] and 18.3%, respectively, as on December 31, 2020 against 12.3% and 15.8%, respectively, as on December 31, 2019. The capital ratios were supported by steady capital accretion with limited growth in the book and lending to lower risk-weighted segments. While DCB Bank's reported capital ratios are satisfactory, a sustained improvement in the overall collections and delinquency levels across the retail portfolio will remain key in order to maintain the capital cushions at the existing levels, given the relatively large monitorable book (overdue exposures that are in the 30-60 & 60-90 or special mention account (SMA)-1 & SMA-2 buckets apart from standard restructured advances) in relation to the capital. While the bank has reported high recoverability from slipped exposures in the past, the ability to sustain the same could remain a near-term challenge, given the muted economic environment. Maintaining a strong asset quality will remain critical for DCB Bank's earnings profile, internal capital generation as well as its ability to raise equity capital in future.

Credit challenges

Asset quality and solvency levels could weaken in the near term – DCB Bank's book mainly comprises small ticket size borrowers in the marginal self-employed segments that are vulnerable to income shocks. While the book largely held in the past despite various disruptions, a gradual weakening in the overall asset quality was seen in these segments prior to the onset of Covid-19, with fresh NPA generation at 2.84% in FY2020 against 2.08% in FY2019. During the current year, including proforma slippages, fresh NPA generation remained high at Rs. 465 crore in 9M FY2021 (annualised slippage rate of 2.48%). Even as slippages remained high, the overall recoveries/upgrades remained subdued at Rs. 74 crore (16% of proforma slippages and opening GNPAs for FY2021; Rs. 352 crore and 53%, respectively, in FY2020) as these were constrained due to the lockdowns and the limited legal avenues for pursuing recoveries. Accordingly, including proforma slippages, DCB Bank's GNPA and NNPA ratios weakened to 3.70% and 1.92%, respectively, as on December 31, 2020 from 2.15% and 1.03%, respectively, as on December 31, 2019.

ICRA expects further weakening in the reported asset quality levels in the near term as the overhang of Covid-19 is likely to continue to pose a challenge to the asset quality as well as profitability, given the elevated SMA 1 and SMA 2 books of the bank. While DCB Bank is likely to extend restructuring to some of these borrowers in addition to the relief extended under the Emergency Credit Line Guarantee Scheme (ECLGS), fresh NPA generation could remain high in FY2021 and FY2022. The bank's restructured standard advances accounted for 2.8% of the total standard advances as on December 31, 2020 and are expected to increase to 4.8-5.0% by March 31, 2021. DCB Bank's ability

[1] *ICRA's estimates including profit for 9M FY2021*

to take corrective actions will be critical for its asset quality and remains a monitorable. Furthermore, given the expectation of asset quality pressure, ability of the bank to improve recoveries/upgrades will drive credit cost and the overall profitability, in absence of which RoA is likely to remain at sub-optimal levels in FY2021 and FY2022.

CASA remains below sector average leading to higher cost of funds – DCB Bank's current account and savings account (CASA) levels continue to lag the private sector average with the share of lower-cost CASA deposits accounting for 23% (PVB average of 40-42%) of the total deposits as on December 31, 2020. This has remained at similar levels of 21-24% over the past three years. Nevertheless, given the relatively longer tenure of the assets, the bank has focused on building a granular term deposit base on the back of its higher interest rate offerings. While this strategy has helped it reduce the depositor concentration levels to 7.28% as on December 31, 2020 from 14.87% as on March 31, 2018, the overall cost of funds remains higher than the sector average. DCB Bank's cost of funds moderated to 6.63% in 9M FY2021 from 7.00% in FY2020 amid a declining interest rate regime, although the differential with the private sector average remained high at ~160 bps to ~170 bps.

Cost-to-income remains above sector average; improvement in operational leverage unlikely in the near term – DCB Bank added ~120 new branches in FY2017 and FY2018 following which the pace of branch expansion slowed down with ~30 branches added during FY2019-9M FY2021. Accordingly, net advances grew by ~16% in FY2019 and slowed down thereafter to ~8% in FY2020. The overall growth remained weak in 9M FY2021 due to the impact of Covid-19 with net advances degrowing by ~1% on a YoY basis as on December 31, 2020. This has prevented a meaningful improvement in the cost-to income levels of the bank amid the weak operating environment. The cost-to-income ratio improved to 52% for 9M FY2021 (55% for FY2020) but was on the higher side in relation to the PVB average of ~46%. Due to the onset of Covid-19 and limitations on full-scale operations, the operating expenses, as a percentage of average total assets (ATA), were lower at 2.12% for 9M FY2021 (2.44% in FY020). In ICRA's opinion, the operational leverage will improve gradually as the scale of operations grows, though the same is unlikely to be achieved in the near term. Further, cross-sell opportunities are limited given the low share of the corporate loan book and the marginal profile of the borrowers. Thus, the non-interest income (1.01% of ATA in FY2020 and 0.64% in 9M FY2021) is lower than the PVB average (1.45% in FY2020 and 1.03% in H1 FY2021).

Liquidity position: Adequate

DCB Bank has negative cumulative mismatches in the near-term bucket of two months till one year. The cumulative gaps remain manageable at ~4%% of the total outflows in the one-year maturity bucket as on December 31, 2020. Further, the bank's daily average liquidity coverage ratio (LCR) is strong at 142% for Q3 FY2021. Besides this, the bank's excess statutory liquidity ratio (SLR) holding above the regulatory levels stood at 5% of net demand and time liabilities as on December 31, 2020, which can be utilised to avail liquidity support from the RBI (through reverse repo) apart from the marginal standing facility of the RBI in case of urgent liquidity needs.

Rating sensitivities

Positive factors – DCB Bank's ability to meaningfully reduce the overdue book, improve the granularity of the deposits while reducing the gap between its cost of borrowed funds and that of peer private banks, and improve its profitability will be a positive trigger.

Negative factors – If the solvency metric (Net NPA/Core equity) weakens beyond 25% or if the capital cushions of the bank over the regulatory Tier I requirement (9.5%) reduce below 2% on a sustained basis, the ratings could be downgraded. This apart, the weakening of the internal capital generation with an RoA <0.7-0.8% on a sustained basis or a deterioration in the deposit franchise will remain negative triggers.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Rating Methodology for Banks
Parent/Group Support	Not applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the standalone financials of DCB Bank Limited

About the company

Incorporated in 1995, DCB Bank was formed through the merger of Ismailia Co-operative Bank Limited and Masalawala Cooperative Bank. The Aga Khan Fund for Economic Development (AKFED) and Group companies are the largest shareholders in the bank with a combined stake of 14.88% as on December 31, 2020. DCB Bank had a network of 347 branches as on December 31, 2020. It reported a profit after tax (PAT) of Rs. 338 crore in FY2020 compared with a PAT of Rs. 325 crore in FY2019. In 9M FY2021, DCB Bank reported a PAT of Rs. 258 crore vis-à-vis a PAT of Rs. 269 crore in 9M FY2020.

Key financial indicators (standalone)

DCB Bank		FY2019	FY2020	9M FY2020	9M FY2021
Net interest income	Rs. Crore	1,149	1,265	941	975
Profit before tax	Rs. Crore	507	492	398	349
Profit after tax	Rs. Crore	325	338	269	258
Net advances	Rs. Crore	23,568	25,345	25,438	25,300
Total assets	Rs. Crore	35,792	38,505	38,057	37,859
% CET	%	13.1%	13.9%	12.3%	14.3%
% Tier I	%	13.1%	13.9%	12.3%	14.3%
% CRAR	%	16.8%	17.8%	15.8%	18.3%
% Net interest margin / Average total assets	%	3.51%	3.43%	3.51%	3.41%
% Net profit / Average total assets	%	0.99%	0.92%	1.00%	0.90%
% Return on net worth	%	11.33%	10.61%	11.94%	9.68%
% Gross NPAs	%	1.84%	2.46%	2.15%	3.70%^
% Net NPAs	%	0.65%	1.16%	1.03%	1.92%^
% Provision coverage excl. technical write-offs	%	65%	54%	53%	49%^
% Net NPA/ Core capital	%	6.6%	10.5%	8.21%	13.84%^

Source: *DCB Bank Limited, ICRA research; All ratios as per ICRA calculations*

^ Proforma numbers including proforma NPAs and standstill slippages as directed by the Hon'ble Supreme Court

Status of non-cooperation with previous CRA: Not applicable

Any other information: Not applicable

Rating history for past three years

S No	Name of Instrument	Current Rating (FY2021)				Chronology of Rating History for the Past 3 Years			
		Type	Rated Amount (Rs. crore)	Amount Outstanding (Rs. crore)	Feb 26, 2021	FY2020	FY2019	FY2018	
						Jan 31, 2020	Dec 28, 2018	Nov 23, 2017	Nov 16, 2017
1	Short-term Fixed Deposits	Short Term	-	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
2	Basel III Compliant Tier II Bonds Programme	Long Term	550.00	536.60^	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)

^ Balance yet to be placed

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 click here

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE503A08010	Basel III tier II bonds	Mar 31, 2016	10.25%	Apr 30, 2026	86.60	[ICRA]A+(hyb) (Stable)
INE503A08028	Basel III tier II bonds	Nov 18, 2016	9.85%	Nov 18, 2026	150.00	[ICRA]A+(hyb) (Stable)
INE503A08036	Basel III tier II bonds	Nov 17,2017	9.85%	Nov 17, 2027	300.00	[ICRA]A+(hyb) (Stable)
Proposed	Basel III tier II bonds	NA	NA	NA	13.40	[ICRA]A+(hyb) (Stable)
NA	Short-term fixed deposits	NA	NA	NA	NA	[ICRA]A1+

Source: *DCB Bank Limited*

Key features of rated debt instruments

The letters hyb, in parenthesis, suffixed to a rating symbol stand for hybrid, indicating that the rated instrument is a hybrid subordinated instrument with equity-like loss-absorption features; such features may translate into higher levels of rating transition and loss severity vis-à-vis conventional debt instruments. The rated Tier II bonds under Basel III are expected to absorb losses once the point of non-viability (PONV) trigger is invoked.

Annexure-2: Not Applicable

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