March 30, 2021

The Karur Vysya Bank Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III - Tier-II Bonds	1,200.00	1,200.00	[ICRA]A(hyb) (Stable); reaffirmed
Certificates of Deposit Programme	3,000.00	3,000.00	[ICRA]A1+; reaffirmed
Total	**4,200.00**	**4,200.00**	

**Instrument details are provided in Annexure-1*

Rationale

The rating reaffirmation factors in The Karur Vysya Bank Limited's (KVB) established franchise in South India, its adequate capitalisation (CET I ratio of 16.46% in December 2020) and the strong liquidity profile (liquidity coverage ratio of 368% in December 2020). The ratings also factor in steady improvement in the deposit profile, with current accounts and savings account (CASA) increasing to 34.6% of the total deposits as of December 2020 (31.3% in March 2020) from 27.7% in March 2017. The rating, however, considers likely pressure on asset quality with proforma slippages (2.7% annualised in 9M FY2021) and the management guidance of gross slippages and restructuring of 2.25% each for FY2021. This, coupled, with elevated level of net stressed assets[1] (NSA) of Rs. 2,449 crore (36.7% of core equity capital[2] as on December 31, 2020 as against 44.5% as on March 31, 2019) will keep the credit provisions and profitability pressure high even in FY2022. Although, the headline solvency seems modest, however, if NSA and core capital is adjusted for surplus capital (excess capital over Tier 1 of ~13%), the solvency profile is relatively better.

Subsequent to the asset quality pressures witnessed during last few years as reflected in high Gross NPAs (9.07% as of December 2020 on a proforma basis), the bank has been in consolidation phase, as reflected in limited growth in the overall loan book and reduction in the share of wholesale loan. Further, the bank has also been focusing on changing the composition of loan book to more granular retail and jewel loans, which has enabled bank to reduce its risk weighted assets (RWAs) and improve capital ratios despite pressure on internal capital generation during the last few years. Given the asset quality challenges faced by the bank in recent past, the bank has undertaken changes in underwriting process with centralisation of credit underwriting across the retail and commercial segments. The bank has started KVB NEO during last year to digitally acquire, underwrite and disburse loans for both retail and SME customers. While asset quality pressures have remained high, the overdue loans (30+ days past due - dpd) have steadily declined during the last few years, which provides some comfort on the incremental stress beyond what is reported and guided by the management. Though internal capital generation is likely to remain weak over FY2021-2022, however the bank may not require any external capital to achieve a compounded annual growth rate (CAGR) of 8-10% over the next couple of years, while maintaining sufficient cushion above the regulatory capital requirement. Apart from the above factors, the modest scale and geographically concentrated nature of operations with ~64% of the loan book from the state of Tamil Nadu (50%) and Andhra Pradesh (14%) also remain as constraining factors.

The Stable outlook on the long-term rating factors in ICRA's expectations that the guidance on asset quality and consequent expectations of improvement in solvency profile by end-FY2022, while internal capital generation is likely to improve to acceptable levels during FY2023.

[1] *Net stressed assets include net proforma non-performing advances, net security receipts and net non-performing investments*

[2] *Core equity capital including profits for 9M FY2021*

Key rating drivers and their description

Credit strengths

Granular liability profile supported by its established retail franchise - KVB has an operational track record of more than 10 decades with an established retail franchise in South India. The bank's branch network stood at 780 as on December 31, 2020, of which 86% were in the southern states of Tamil Nadu, Andhra Pradesh, Telangana, Kerala and Karnataka. However, as the bank was in its consolidation phase, the total branches marginally declined from 790 as on March 31, 2018. With muted advances growth in the last couple of years, the need to raise higher cost term deposits remained lower, which, coupled with steady growth in CASA deposits, resulted in improved share of CASA in its overall deposits. Despite an improvement in the CASA deposit share, it remained below the private bank (PVB) average of 41% - 43% but was better as compared to peers.

The bank's deposit base remains granular with limited dependence on wholesale deposits, which is evidenced by a relatively lower share of bulk deposits (above Rs. 2 crore) at 6.2% of total deposits as on December 31, 2020 and top 20 depositors accounted for only 6% of total deposits as on December 31, 2020 which was lower than its peers.

The rise in CASA deposits and lower dependence on bulk deposits resulted in an improvement in cost of interest-bearing funds to 5.1% in 9M FY2021 compared to 5.9% in 9M FY2020. While the cost of interest-bearing funds remains marginally above the PVBs average (4.7% during 9M FY2021), the differential has declined over the years. This, could enable the bank to compete in better customer segments while maintaining its profitability.

Adequate capitalisation profile – The bank has an adequate capitalisation profile with CET I ratio of 16.46% (~17.1% including profits for 9M FY2021) as on December 31, 2020 compared to 14.14% as on December 31, 2019. The capital ratios are largely supported by rationalisation in risk-weighted assets with RWAs/ net advances at 78.7% as on December 31, 2020 and remained lower than PVBs average of 93.6%. The RWAs declined mainly due to an increase in the share of jewel loans (largely in agricultural lending) and Guarantee Emergency Credit line (GECL) portfolio at 28.4% of net advances, which attracts nil RWAs. This has enabled the bank to improve its capital ratios, despite pressure on internal capital generation during the last few years (return on equity - RoE of 5.1% in 9M FY2021 and 3.6% in FY2020).

Though KVB's reported capital ratios are higher compared to its peers, the bank has a high level of unprovided stressed assets, with an NSA of ~Rs. 2,449 crore as on December 31, 2020, which, if provided, will result in lower capital ratios. As a result, the provisions for the bank are expected to remain high, resulting in subdued internal capital generation over FY2022. Nonetheless, as per ICRA's estimate, the bank would not require additional capital for maintaining a 2-3% cushion over the Tier-1 regulatory requirement, to achieve an advance CAGR of 8% -10% over the next couple of years.

Increasing focus on granular retail assets – Given high slippages in the corporate segment (> Rs. 25 crore), the bank changed its strategy to focus on granular assets in the commercial (~MSME) (<= Rs. 25 crore) and the retail (up to Rs. 10 crore) segments. As a result, the share of the corporate segment declined to 24% of gross advances as on December 31, 2020 from 33% as on March 31, 2017 while the retail segment share increased to 22% as on December 31, 2020 from 15% as on March 31, 2017. The bank also has a sizeable exposure towards secured jewel loans (~23% of the gross advances) as on December 31, 2020, largely classified under the agriculture segment with an average loan to value (LTV) of ~72% and yield of ~8.3%. Further, the bank witnessed consistent decline in top 20 exposure to 7.2% (67% of Tier I capital) of total exposure as on March 31, 2020 compared to 9.8% (107%) as on March 31, 2017. The loan book granularity is also reflected in a decline in corporate advances of >Rs. 100 crore to 7.8% of gross advances as on December 31, 2020 from 10.5% as on March 31, 2017. With increasing granularisation of the loan book, the growth in RWAs is expected to be modest in relation to the overall advances growth, resulting in limited capital consumption in the near-to-medium term.

Credit challenges

Asset quality pressures induced by Covid 19; solvency profile is modest given high level of stressed assets - KVB's higher slippages in corporate (GNPA ratio of ~19% -21%) and commercial segment (GNPA ratio of ~6 -7%) in the last few years have put pressure on asset quality. While the asset quality pressures were expected to ease off in FY2021, however, driven by Covid-

19 pandemic the bank reported proforma slippages of ~Rs. 885 crore in 9M FY2021 (annualised slippage of 2.7%). As a result, the bank's reported Gross NPAs and Net NPAs remain elevated 9.07% and 4.08%, respectively as on December 31, 2020 (8.69% and 3.92% as on March 31, 2020). In addition, including the exposure through security receipts, the NSA is estimated at 36.7% of core capital as on December 31, 2020 (44.5% as on March 31, 2019). However, on an adjusted basis, the solvency ratio has witnessed an improvement to ~20% level as on December 31, 2020 (~41% as on March 31, 2019).

Further, with the management's guidance on gross slippage and restructuring of 2.25% each, the asset quality will remain monitorable in near future. ICRA also notes that the bank has a high share of BB and below and unrated book typically due to small / mid-size borrowers. It has a long relationship with many of these customers and its overdue status (30+dpd) of 2.5% as on December 31, 2020 (9.0%+ as on March 31, 2017) provides some comfort on incremental stress. Overall, the bank's ability to contain incremental slippages and undertake effective recoveries would be key for its profitability and solvency.

Internal capital generation to remain modest during FY2022 driven by high credit provisions - The bank's operating profitability was impacted in FY2021 because of the rise in employee expenses due to a one-time expense related to wage settlement provision in Q3 FY2021. In addition, muted loan growth, high level of stressed assets and lower share of fee income also supresses operating profitability. KVB witnessed a decline in core operating profit to Rs. 828 crore (1.57% of average total assets – ATA) in 9M FY2021 compared to Rs. 1,047 crore (1.97% of ATA) in 9M FY2020, mainly driven by these factors. However, the core operating profitability pressure was partially offset by treasury income of Rs. 352 crore (0.67% of ATA) in 9M FY2021 from Rs. 203 crore (0.38% of ATA) in 9M FY2020.

While the operating profitability is likely to recover in FY2022, given the elevated level of NSAs, the credit provisions for the bank will remain high, which would translate into pressure on profitability. As per ICRA's estimates, the credit provisions for FY2021 and FY2022 are estimated to remain elevated at ~1.4-1.5% and ~1.2-1.5% of advances, which will translate into return on asset (RoA) of ~0.4-0.5% for FY2021 and FY2022, respectively. This is, however, likely to improve from FY2023, if the asset quality stress emerges as per that guided by the management.

Moderate scale and geographically concentrated operations - KVB's net advances and deposits stood at Rs. 49,512 crore and Rs. 62,089 crore, respectively, as on December 31, 2020 accounting for about ~0.5% each, of the banking sector. The bank's business growth has been subdued in the recent past, as it is in a period of consolidation; its net advances and deposits grew at a CAGR of 4.1% and 3.2%, respectively, during FY2017 - FY2020 compared to the PVBs average of 16.4% and 15.5%, respectively (7.6% and 7.4%, respectively, for the overall banking sector). With plans to open 20 to 30 branches over the next three years, the bank's operations are likely to remain modest and regionally concentrated over the medium term.

Liquidity position: Strong

The bank's liquidity coverage ratio (LCR) remained high at 368.0% in Q3 FY2021 against the regulatory requirement of 100% from April 1, 2021. The LCR has been supported by excess holding in Government securities and higher share of stable deposits (rollover of term deposits at about 70%). As per the structural liquidity statement for November 30, 2020, the bank has positive cumulative mismatches (inflows higher than outflows) across all the buckets in the less than 1-year segment. The bank had an excess SLR holding of 10.8% of the net demand and time liabilities as on December 4, 2020 (5.7% as on April 10, 2020).

Rating sensitivities

Positive factors – ICRA could revise the outlook to Positive or upgrade the ratings, if the bank continues to improve the granularity of the loan book and the asset quality, resulting in an improvement in solvency profile with net stressed assets / core equity improving to less than 25% on a sustained basis while maintaining capital cushions of >2% over the regulatory levels. The bank's ability to improve the profitability, with an RoA of > 1.0% on a sustained basis would also be a rating trigger.

Negative factors – ICRA could revise the outlook to Negative or downgrade the ratings if there is a substantial deterioration in the liability franchisee or further weakening in asset quality or solvency position with the net stressed assets / core equity remaining above 35% for a prolonged period or the capital cushion decline 2% below the regulatory levels.

Analytical approach

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

About the company

Incorporated in 1916 by the local trader community, Karur Vysya Bank (KVB) is one of the old private sector banks in the country. KVB is a South-based bank and was formed to provide financial support to the traders and agriculturists in and around Karur, Tamil Nadu. As on December 31, 2020, it had a network of 780 branches with South India constituting 86% of the total branches. The bank's net advances stood at Rs. 49,512 crore as of December 2020, with presence in corporate, commercial, retail and agriculture segments. During FY2018, the bank embarked on a business model transformation to centralise its credit functions. In FY2020, it took a strategic initiative 'KVB Neo' to enable business growth by leveraging technology and partnering with fintech companies. In 9M FY2021, the bank reported a net profit of Rs. 255 crore on an asset base of Rs. 72,598 crore compared to a net profit of Rs. 151 crore on an asset base of Rs. 72,655 crore in 9M FY2020.

Key financial indicators (audited)

The Karur Vysya Bank Limited	FY2019	FY2020	9M FY2020	9M FY2021^
Net interest income	2,363	2,348	1,757	1,747
Profit before tax	322	272	202	356
Profit after tax	211	235	151	255
Net advances	48,581	46,098	47,119	49,512
Total assets	69,340	68,278	72,655	72,598
% CET I	14.28%	15.27%	14.14%	16.46%
% Tier I	14.28%	15.27%	14.14%	16.46%
% CRAR	16.00%	17.17%	15.87%	18.52%
% Net interest margin	3.47%	3.41%	3.30%	3.31%
% PAT / ATA	0.31%	0.34%	0.28%	0.48%
% Return on net worth	3.28%	3.56%	3.12%	5.05%
% Gross NPAs	8.79%	8.69%	8.92%	9.07%
% Net NPAs	4.98%	3.92%	4.13%	4.08%
% Provision coverage excl. technical write-offs	45.61%	57.07%	56.01%	57.38%
% Net NPA/ Core equity capital	38.76%	28.24%	31.28%	31.44%

Note: Amount in Rs. crore; All calculations are as per ICRA research
Total assets and net worth exclude revaluation reserves
^ Asset quality figures are on proforma basis, Quarterly results are unaudited while annual results are audited
Source: KVB, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2021)				Chronology of Rating History for the past 3 years				
		Type	Amount Rated (Rs. crore)	Amount Outstanding as of Mar 22, 2021 (Rs. crore)	Date & Rating in	Date & Rating in FY2020	Date & Rating in FY2019			Date & Rating in FY2018
					Mar 30, 2021	Feb 10, 2020	Feb 22, 2019	Jan 11, 2019	Aug 30, 2018	Jul 13, 2017
1	Basel III compliant Tier II Bonds	Long-term	1,200.00	487.00^	[ICRA]A (hyb) (Stable)	[ICRA]A (hyb) (Stable)	[ICRA]A (hyb) (Stable)	[ICRA]A+ (hyb) (negative)	-	-
2	Lower Tier II Bonds Programme	Long-term	-	-	-	[ICRA]A (Stable); withdrawn	[ICRA]A (Stable)	[ICRA]A+ (negative)	[ICRA]A+ (negative)	[ICRA]A+ (stable)
3	Certificates of Deposit Programme	Short-Term	3,000.00	Nil^	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

^ Data as on March 22, 2021

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 www.icra.in

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (RS Crore)	Current Rating and Outlook
INE036D08015	Basel III - Tier II Bonds	12-Mar-2019	11.95%	12-Jun-2029	487.00	[ICRA]A (hyb) (Stable)
NA#	Basel III - Tier II Bonds	NA	NA	NA	713.00	[ICRA]A (hyb)(Stable)
NA	Certificates of Deposit Programme	-	-	-	3,000.00	[ICRA]A1+

Source: *KVB*

 # Yet to be placed

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: List of entities considered for consolidated analysis - Not applicable

ANALYST CONTACTS

Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Anil Gupta
+91 124 4545 314
anilg@icraindia.com

Niraj Jalan
+91 33 7150 1146
niraj.jalan@icraindia.com

Aayush Behal
+91 124 4545 300
aayush.behal@icraindia.com

RELATIONSHIP CONTACT

Mr. L. Shivakumar
+91 22 6114 3406
shivakumar@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

ICRA Limited

Registered Office

1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website www.icra.in or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.