February 21, 2022

DCB 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 Bond Programme	313.4	313.4	[ICRA]A+ (Stable); reaffirmed
Basel III Tier II Bond Programme	236.6	0.0	[ICRA]A+ (Stable); reaffirmed and withdrawn
Short-term Fixed Deposit Programme	-	-	[ICRA]A1+; reaffirmed
Total	**550.00**	**313.4**	

**Instrument details are provided in Annexure*

Rationale

The ratings reaffirmation factors in DCB Bank Limited's (DCB) comfortable capital cushions with Tier-I and CRAR at 15.1% and 18.2% (excluding profits for 9M FY2022), respectively, while deposit granularisation has continued to progress satisfactorily, leading to lower concentration levels from the significantly higher levels seen in the past. Further, the Covid-19 pandemic-induced slippages witnessed a sharp rise in 9M FY2022, leading to elevated credit costs and weaker profitability levels. The weakening in the asset quality was partly due to the bank's customer profile, mainly comprising small-ticket borrowers in the self-employed segment, that was more severely impacted by the pandemic. Nevertheless, collections and recoveries were satisfactory and helped offset the impact of high slippages to a certain extent. Moreover, the overall book remains well collateralised, thereby lowering DCB's credit losses. The overall standard restructured book remains high at ~8% of standard advances as on December 31, 2021. This, together with the sizeable overdue book (special mention account (SMA)-1 & SMA-2), remains materially high in relation to the capital. These monitorable pools of loans could remain a potential source of incremental stress, which could delay the improvement in the asset quality and profitability from the current levels over the near term.

Further, DCB's cost profile remains relatively weak, with the cost of funds as well as the cost-to-income ratio remaining comparatively higher than the private sector banks' (PVB) average. While the bank's stated growth guidance of doubling the book over the next 3-4 years may help derive operational leverage over the long term, the operating expenses necessary for expanding the franchise are likely to remain high in the near term. Additionally, the bank's ability to match the book growth by mobilising deposits at competitive rates, thereby narrowing the differential with the PVB average while sustaining granularity, will remain key for building a stable franchise and improving the cost metrics.

The Stable outlook on the rating reflects the expectation that the bank will be able to maintain high recoverability from its pool of non-performing advances (NPAs) while ensuring that the solvency levels (net non-performing loans/core capital) and capital cushions remain above the negative rating triggers. The possibility of near-term asset quality challenges from a sizeable monitorable book and higher operating expenses could keep the profitability at sub-optimal levels (<1%) in the near term.

Key rating drivers and their description

Credit strengths

Comfortable capital cushion – DCB's capital ratios (including current year's profits) remain comfortable with Tier-I and CRAR at 15.8% and 18.9%, respectively, (15.1% and18.2%, respectively, excluding profits for 9M FY2022) as on December 31, 2021 against 15.4% and 19.5%, respectively, as on December 31, 2020 (14.3% and 18.3%, respectively, excluding profits for 9M FY2021). DCB's capitalisation profile continues to derive support from its business profile, with focus on small-ticket retail loans (mainly mortgages) that attract lower risk weight. Additionally, the bank's book has grown at a relatively slower pace following the onset of the pandemic, leading to lower capital consumption, while internal capital accretion remained weak due to elevated credit costs.

Looking ahead, near-term asset quality pressures stemming from the large overdue and restructured book will remain a monitorable as this could continue to weigh down on DCB's internal capital generation. While the current operating profitability and expected recoveries are likely to absorb a large part of the incremental credit costs, the overall impact on DCB's capital cushions, if any, is likely to remain limited. Looking ahead, a sustained improvement in internal capital generation will be critical for maintaining the capital cushions, given the bank's stated growth targets for the next 3-4 years.

Deposit concentration maintained at satisfactory levels – DCB's overall deposit base grew by 12% YoY to Rs. 32,231 crore as on December 31, 2021, while net advances grew by 9% during this period to Rs. 27,659 crore as on December 31, 2021. Further, during this period, the overall granularisation of the deposit base continued to progress satisfactorily with the share of the top 20 depositors gradually moderating to ~6% of total deposits as on December 31, 2021 from ~7% as on March 31, 2021, ~9% as on March 31, 2020 and ~15% as on March 31, 2018. Additionally, the share of bulk deposits (deposits >Rs. 2 crore) reduced progressively to ~27% as on September 30, 2021 from ~47% as on March 31, 2019. The improvement in the deposit granularity was also supported by slower book growth, which, in turn, eased the need to mobilise bulk deposits.

Given the growth targets of the bank for the coming 3-4 years, the ability to limit dependence on bulk deposits while pursuing stronger book growth will remain to be seen. Nevertheless, DCB continues to take steps towards growing its retail term depositor base as well as retail savings accounts (ticket size <Rs. 2 crore), albeit at a higher cost.

Credit challenges

Weaker asset quality levels; incremental asset quality pressure expected to persist in the near term – Various regulatory and policy interventions helped contain fresh NPA generation at 2.74% in FY2021. However, the annualised fresh NPA generation rate rose sharply to 7.3% of standard advances in 9M FY2022 with the gradual withdrawal of these schemes together with the impact of the second Covid-19 wave on a book largely comprising small ticket size borrowers in the self-employed segment. As a result, DCB's headline asset quality metrics continued to weaken with gross NPA (GNPA) and net NPA (NNPA) at 4.73% and 2.52%, respectively, as on December 31, 2021 (3.70% and 1.92%, respectively, including proforma slippages as on December 31, 2020). Over and above this, the overall standard restructured book remained high at ~8% of standard advances as on December 31, 2021 (net of provisions at ~7%), which together with the sizeable overdue book (SMA-1 & SMA-2) will remain a near to medium term monitorable.

ICRA, however, notes that recoveries and upgrades (to a certain extent supported by restructuring) remained meaningfully high in 9M FY2022 at Rs. 1,051 crore (including cash recovery of Rs. 369 crore) against gross slippages of Rs. 1,394 crore, which, in turn, kept net slippages at a relatively manageable level for the bank. Going forward, the performance of the overdue loan book and restructured loan book (a sizeable portion of which is under moratorium) and DCB's ability to arrest slippages as well as sustain high recoveries will be key for ensuring an improvement in the asset quality metrics from the current levels.

Near-term profitability expected to be weighed down by asset quality pressures and planned franchise expansion – The weaker asset quality, excess liquidity and slower book growth continued to lead to a steady moderation in the net interest margin/average total assets (NIM/ATA) to 3.23% in 9M FY2022 from 3.29% in FY2021 and 3.41% in FY2020. While the impact of the rapid branch expansion undertaken during FY2017-18 on the cost-to-income ratio continued as book growth slowed, the ongoing/planned expansion of the franchise with investment in infrastructure and employee headcount kept operating expenses/ATA elevated at 2.44% in 9M FY2022 against 2.17% in FY2021 and 2.43% in FY2020. This led to the weakening of the cost-to-income ratio to 60.17% in 9M FY2022 (52.83% in FY2021 and 56.4% in FY2020). As a result, the pre-provision operating profitability moderated to 1.61% in 9M FY2022 from 1.94% in FY2021. Further, as a result of elevated credit costs at 1.12% of ATA in 9M FY2022 (0.66% in FY2021 and 0.4% in FY2020), the return on assets (RoA) weakened to 0.57% in 9M FY2022 (0.86% in FY2021 and 0.91% in FY2020).

Going forward, the profitability levels are expected to remain weaker and below 1.0% and will be driven by the performance of the monitorable book. Stronger book growth will provide better operational leverage, which, along with better asset quality levels, will be key for a sustained improvement in the profitability.

Cost of funds remains high in relation to industry average – DCB's overall cost of funds in relation to the PVB average increased gradually to ~183 bps in FY2021 and further to ~220 bps in H1 FY2022 from ~100 bps in FY2019. The differential was largely due to the ongoing efforts to maintain deposit granularity by offering higher interest rates to retail depositors. Further, the share of lower-cost current and saving accounts (CASA) stood at 26% as on December 31, 2021, which continues to lag the PVB average of 44-45%, leading to relatively higher costs compared to peer banks. Although DCB has begun repricing higher-ticket savings deposits at a higher level, these are priced lower than the retail term deposits, which, in turn, is aimed at growing the CASA from the current level. While the higher interest rate proposition has been effective at moderating the depositor concentration levels, the bank's ability to narrow the cost differential meaningfully, while ensuring the growth of granular deposits and pursuing stronger book growth, will be a challenge.

Liquidity position: Adequate

With net advances growth lagging deposit accretion, the liquidity cushions widened with the statutory liquidity ratio (SLR) reported at 26-29% of the net demand and time liabilities (NDTL) over March 2021-December 2021, which was higher than the regulatory minimum requirement of 18%. The excess SLR can be utilised to avail liquidity support from the Reserve Bank of India (RBI; through reverse repo) apart from the marginal standing facility of the RBI in case of urgent liquidity needs. Moreover, DCB's surplus liquidity position helped in maintaining positive cumulative mismatches in the near-term maturity buckets as on September 30, 2021, which was in contrast to the negative gaps seen in the past. Its daily average liquidity coverage ratio (LCR) also remained satisfactory at 125% for Q3 FY2022 against the regulatory requirement of 100%.

Rating sensitivities

Positive factors – DCB'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 (NNPA/Core equity) weakens beyond 25% or if the capital cushions 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 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

About the company

Incorporated in 1995, DCB 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, 2021. DCB had a network of 367 branches and 353 ATMs as on December 31, 2021.

Key financial indicators (audited)

DCB Bank Limited		FY2020	FY2021	9M FY2021	9M FY2022
Net interest income	Rs. crore	1,265	1,287	975	977
Profit before tax	Rs. crore	492	453	349	236
Profit after tax	Rs. crore	338	336	258	174
Net advances	Rs. crore	25,345	25,959	25,300	27,659
Total assets	Rs. crore	38,505	39,602	37,859	41,178
% CET	%	13.9%	15.5%	14.3%*	15.1%*
% Tier-I	%	13.9%	15.5%	14.3%*	15.1%*
% CRAR	%	17.8%	19.7%	18.3%*	18.2%*
% Net interest margin / Average total assets	%	3.41%	3.29%	3.41%	3.23%
% Net profit / Average total assets	%	0.91%	0.86%	0.90%	0.57%
% Return on net worth	%	9.87%%	8.93%	9.68%	6.03%
% Gross NPAs	%	2.46%	4.10%	3.70%^	4.73%
% Net NPAs	%	1.16%	2.29%	1.92%^	2.52%
% Provision coverage excl. technical write-offs	%	54%	45%	49%	48%
% Net NPA/ Core capital	%	10.5%	17.2%	13.84%^	19.39%

***Source:** DCB Bank Limited, ICRA Research; All ratios as per ICRA's calculations,* Excluding profits for the year*

^ 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: None

Rating history for past three years

S No	Name of Instrument	Current Rating (FY2022)				Chronology of Rating History for the Past 3 Years		
		Type	Rated Amount (Rs. crore)	Amount Outstanding (Rs. crore)	Feb 21, 2022	FY2021	FY2020	FY2019
						Feb 26, 2021	Jan 31, 2020	Dec 28, 2018
1	Short-term Fixed Deposits	Short Term	-	-	**[ICRA]A1+**	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
2	Basel III Tier II Bonds Programme	Long Term	313.4	300.0^	**[ICRA]A+ (Stable)**	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)
3	Basel III Tier II Bonds Programme	Long Term	236.6	0.0	**[ICRA]A+ (Stable) withdrawn**	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)

^ Balance yet to be placed

Removal of (hyb) suffix from Basel III instruments

In compliance with the circular issued by the Securities and Exchange Board of India (SEBI) on July 16, 2021 for standardising the rating scales used by credit rating agencies, ICRA has discontinued its practice of affixing the (hyb) suffix alongside the rating symbols for hybrid instruments. Accordingly, ICRA has removed the (hyb) suffix that was earlier being placed alongside the rating symbol for the hybrid instruments issued by DCB. The earlier and revised denotation of the rating for various instruments can be seen in the table above. This rating action only involves the removal of the (hyb) suffix and should not be construed as a change in the credit rating.

Complexity level of the rated instrument

Instrument	Complexity Indicator
Basel III Compliant Tier II Bond Programme	Highly Complex
Short-term Fixed Deposit Programme	Very Simple

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional, or legal aspects. Details on the complexity levels of the instruments are available on ICRA's website: www.icra.in

Annexure-1: Instrument details

ISIN	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+ (Stable) withdrawn
INE503A08028	Basel III tier II bonds	Nov 18, 2016	9.85%	Nov 18, 2026*	150.00	[ICRA]A+ (Stable) withdrawn
INE503A08036	Basel III tier II bonds	Nov 17,2017	9.85%	Nov 17, 2027	300.00	[ICRA]A+ (Stable)
Proposed	Basel III tier II bonds	NA	NA	NA	13.40	[ICRA]A+ (Stable)
NA	Short-term fixed deposits	NA	NA	NA	NA	[ICRA]A1+

Source: *DCB Bank Limited,* Call option exercised, and bonds redeemed on Dec 27, 2021*

Key features of rated debt instruments

The servicing of the Basel III Tier II Bonds is expected to absorb losses once the point of non-viability (PONV) trigger is invoked by the RBI. The Basel III Tier II Bonds have equity-like loss-absorption features. Such features may translate into higher loss severity vis-à-vis conventional debt instruments.

Annexure-2: List of entities considered for limited consolidated analysis

Not Applicable

ANALYST CONTACTS

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

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

Aashay Choksey
+91 22 6114 3430
aashay.choksey@icraindia.com

Samiksha Karnavat
+91 22 6114 3471
samiksha.karnavat@icraindia.com

RELATIONSHIP CONTACT

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

B-710, Statesman House, 148, Barakhamba Road, New Delhi-110001
Tel: +91 11 23357940-45

Branches