November 27, 2023

The Karur Vysya Bank Limited: Long-term rating upgraded to [ICRA]AA- (Stable); Short-term rating 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]AA- (Stable); upgraded from [ICRA]A+ (Stable)
Certificates of Deposit (CD)	3,000.00	3,000.00	[ICRA]A1+; reaffirmed
Total	**4,200.00**	**4,200.00**	

**Instrument details are provided in Annexure I*

Rationale

The rating upgrade factors in the sustained improvement in The Karur Vysya Bank Limited's (KVB) earnings profile and solvency[1] levels, primarily driven by the enhanced asset quality levels. The improvement in the asset quality was driven by the moderation in the fresh non-performing advances (NPA) generation rate as well as the healthy recoveries, which led to a decline in the credit costs. Furthermore, the overall capitalisation {core equity tier ratio (CET I) of 15.19% as of September 2023} has remained comfortable.

While the overall vulnerable book, comprising the standard restructured book and the SMA[2] accounts, witnessed a sustained decline to 1.9% of standard advances as on September 30, 2023 (2.75% as of September 2022), the residual vulnerable book would remain a monitorable from a profitability and asset quality perspective. Despite the above improvements, the regional concentration of KVB's operations remains high, exposing its assets and liabilities to local socio-economic and political risks.

The Stable outlook on the rating reflects ICRA's expectation that the improvement in the earnings profile will sustain while the overall solvency and capital positions are likely to remain at comfortable levels in relation to ICRA's negative triggers. Moreover, KVB will continue to maintain a granular asset and liability profile, which will support its liquidity.

Key rating drivers and their description

Credit strengths

Comfortable capitalisation – KVB's capitalisation profile remains comfortable with the reported CET I and CRAR at 15.19% and 16.84%, respectively, as on September 30, 2023 (16.79% and 18.56%, respectively, as on March 31, 2023). Further, the improvement in the bank's profitability in recent quarters (return on equity (RoE) at 16.61% in H1 FY2024 and 12.89% in FY2023) has supported its overall capitalisation profile. The relatively low risk-weighted density of the asset base is driven by the high share of gold loans, which attract a lower risk weight. ICRA expects KVB to maintain comfortable cushions over and above the regulatory Tier I requirements and the negative triggers.

Improvement in earnings profile – KVB's net interest margin (NIM) moderated to 3.84% of average total assets in H1 FY2024 from 3.93% in FY2023 because of the rising deposit cost. With the expectation of continued upward repricing of the deposit base, the NIM is likely to moderate further in H2 FY2024. The bank's operating profitability has improved compared to recent years on the back of better asset quality levels, although elevated operating expenses as well as the relatively lower share of

[1] Solvency is defined as (NNPAs + Net security receipts + Net non-performing investments) / Core capital)

[2] SMA is defined as a special mention account (SMA), which is an account exhibiting signs of incipient stress, resulting in the borrower defaulting in the timely servicing of their debt obligations though the account has not yet been classified as an NPA as per the extant RBI guidelines; SMA-1 accounts are overdue by 31-60 days while SMA-2 accounts are overdue by 61-90 days. The SMA-level data is for the entire bank, including exposures below Rs. 5 crore

non-interest income led to a mild moderation in the operating profitability to 2.73% in H1 FY2024 (2.87% in FY2023, 2.17% in FY2022). However, as credit costs have been declining due to the better asset quality levels, KVB witnessed a steady and sustained improvement in its net profitability levels, with an annualised return on assets (RoA) and return on equity (RoE) of 1.56% and 16.61% in H1 FY2024 (1.30% and 12.89%, respectively, in FY2023 and 0.87% and 8.86%, respectively, in FY2022).

Comfortable asset quality and solvency profile – The headline asset quality continued to witness a sustained improvement with the gross NPA and net NPA (NNPA) at 1.73% and 0.47%, respectively, as on September 30, 2023 (3.98% and 1.36%, respectively, as on September 30, 2022) in contrast to the higher levels in recent years. This was driven by the moderation in the annualised fresh NPA generation rate to 0.99% in H1 FY2024 (0.90% in FY2023) from the relatively higher levels of 2-6% during FY2018-FY2022. Besides this, overall recoveries and upgrades remained healthy during FY2023-H1 FY2024. Further, the bank has increased the provision cover on its past stressed assets and reduced the NNPAs to 0.47% as on September 30, 2023 from the peak of 4.98% as on March 31, 2019. This is expected to maintain the increase in internal capital generation and capitalisation levels, thereby driving a sustained improvement in the solvency profile (3.9% as on September 30, 2023 vis-à-vis 5.68% as on March 31, 2023 and 17.30% as on March 31, 2022). ICRA expects the solvency to remain at a comfortable level in the near to medium term.

Established retail franchise resulting in granular asset and liability base – KVB has an operational track record of more than 10 decades with an established retail franchise in South India. Its branch network stood at 824 as on September 30, 2023, with more than 80% in the southern states of Tamil Nadu, Andhra Pradesh, Telangana, Kerala and Karnataka. Over the years, the bank has built a granular asset profile with the share of the top 20 exposures at 5.09% of total exposures as on March 31, 2023 (5.46% as on March 31, 2022) while it accounted for 51% of the Tier I capital as on March 31, 2023, down from 54% as on March 31, 2022. Further, the deposit base remains granular with limited dependence on wholesale deposits, which is reflected in the high share (~88% of total term deposits) of term deposits of less than Rs. 5 crore, while the top 20 depositors accounted for only 8.92% of the total deposits as on June 30, 2023, which remains lower than its peers.

KVB's current account and savings account (CASA) ratio stood at 32% as on September 30, 2023, and remains lower than the private sector banks' (PVBs) average. Meanwhile, KVB's cost of average interest-bearing funds stood at 5.05% in H1 FY2024 (4.28% in FY2023), above the PVBs' average of 4.95% in Q1 FY2024 (4.15% in FY2023) on account of the relatively lower share of CASA deposits in its overall deposit base.

Credit challenges

Asset quality remains monitorable – The bank's overall stressed book, comprising SMA-1, SMA-2 and the standard restructured book, declined to Rs. 1,284 crore (1.9% of standard advances) as on September 30, 2023, from Rs. 1,634 crore (2.75%) as on September 30, 2022. While the stressed book has moderated and remains comparatively lower than the much higher levels in the past, its performance will remain a monitorable in the near term from an asset quality perspective. Moreover, macro-economic factors, including the sharp rise in inflation, the depreciation of the Indian rupee and the increase in interest rates, could impact certain borrowers. Against this backdrop, KVB's ability to contain slippages and maintain high recovery rates will remain key for ensuring a sustained improvement in the asset quality in the near to medium term.

Moderate scale and geographically concentrated operations – The bank's operations remain geographically concentrated with more than 80% of its total branches (824) located in South India and ~54% in Tamil Nadu as on September 30, 2023 (54% as on September 30, 2022). As the asset and liability profiles are largely granular and retail in nature, their geographical distribution would also be similar. Such concentration exposes the bank's assets to local socio-economic and political risks. ICRA expects KVB's operations to remain regionally concentrated with the same unlikely to improve in the near to medium term.

Environmental and social risks

While banks like KVB do not face material physical climate risks, they are exposed to environmental risks indirectly through their portfolio of assets. If the entities or businesses, to which banks and financial institutions have an exposure, face business disruptions because of physical climate adversities or if such businesses face climate transition risks because of technological, regulatory or customer behaviour changes, the same could translate into credit risks for banks. However, such risk is not material for KVB as it benefits from adequate portfolio diversification. Further, the lending is typically short to medium term, allowing it to adapt and take incremental exposure to businesses that face relatively fewer downside environmental risks.

With regard to social risks, data security and customer privacy are among the key sources of vulnerability for banks as material lapses could be detrimental to their reputation and invite regulatory censure. KVB has not faced material lapses over the years. Customer preferences are increasingly shifting towards digital banking, which provides an opportunity to reduce the operating costs. KVB has been making the requisite investments to enhance its digital interface with its customers. While it contributes to promoting financial inclusion by lending to the underserved segments, its lending practices remain prudent as reflected in the healthy asset quality numbers in this segment compared with its peers.

Liquidity position: Strong

KVB's liquidity coverage ratio (LCR) stood at 249% in Q2 FY2024 (270% in Q1 FY2024 and 257% in Q4 FY2023), driven by the excess statutory liquidity ratio (SLR) holding of Rs. 2,489 crore or 2.95% of net demand and time liabilities (NDTL) as on July 28, 2023, coupled with the low level of non-operational deposits and less stable deposits in total deposits. Further, the net stable funding ratio (NSFR) stood at 134% on September 30, 2023, comfortably above the regulatory requirement of 100% (138.3% on June 30, 2023 and 137.4% on March 31, 2023). As a result, the liquidity profile remains strong and the bank had positive cumulative mismatches in the maturity buckets of up to one year as per its structural liquidity statement as of June 30, 2022.

KVB's ability to maintain a strong liquidity profile will continue to be driven by the high rollover of term deposits. In addition, access to call money markets and the Reserve Bank of India's (RBI) repo and marginal standing facility (MSF) in case of urgent liquidity needs aid KVB's liquidity profile.

Rating sensitivities

Positive factors – ICRA could revise the outlook to Positive or upgrade the rating if the bank increases the geographical diversification of its asset and liability base while maintaining the improvement in its asset quality and profitability.

Negative factors – ICRA could revise the outlook or downgrade the ratings if there is a substantial deterioration in the liability franchise or further weakening in the asset quality or if the solvency position remains weaker than 25% for a prolonged period or the capital cushion over the regulatory Tier I requirements (9.5%) falls below 2.0% on a sustained basis. This apart, the weakening of the internal capital generation with an RoA of less than 0.7% on a sustained basis will remain a negative trigger.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Rating Methodology – Banks and Financial Institutions
Parent/Group support	Not Applicable
Consolidation/Standalone	Standalone

About the company

Incorporated in 1916 by the local trader community, The Karur Vysya Bank (KVB) is one of the oldest private sector banks in the country. It is a South-based bank, which was formed to provide financial support to traders and agriculturists in and around Karur, Tamil Nadu. As on September 30, 2023, it had a network of 824 branches with South India constituting more than 80% of the total branches. The bank's net advances stood at Rs. 69,507 crore as of September 30, 2023, with a presence in the corporate, commercial, retail and agriculture segments. In 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. KVB reported a net profit of Rs. 737 crore in H1 FY2024 on an asset base of Rs. 98,435 crore compared to Rs. 479 crore and Rs. 86,364 crore, respectively, in H1 FY2023.

Key financial indicators

Parameters	FY2022	FY2023	H1 FY2023^	H1 FY2024^
Net interest income	2,715	3,349	1,567	1,812
Profit before tax	931	1,437	666	1,001
Profit after tax	673	1,106	479	737
Net advances (Rs. lakh crore)	0.55	0.63	0.60	0.69
Total assets (Rs. lakh crore)	0.80	0.90	0.86	0.98
CET I	17.49%	16.79%	16.42%*	15.2%*
Tier I	17.49%	16.79%	16.42%*	15.2%*
CRAR	19.46%	18.56%	18.31%*	16.8%*
Net interest margin / ATA	3.51%	3.93%	3.76%	3.84%
PAT / ATA	0.87%	1.30%	1.15%	1.56%
Return on net worth	8.86%	12.89%	12.23%	16.61%
Gross NPAs	5.99%	2.27%	3.98%	1.73%
Net NPAs	2.28%	0.74%	1.36%	0.47%
Provision coverage excl. technical write-offs	63.40%	67.9%	66.67%	73.4%
Net NPA / Core equity capital	17.30%	5.68%	10.71%	3.93%

Source: Company, ICRA Research; ^Provisional
All ratios as per ICRA's calculations
Amount in Rs. crore
**Excludes H1 profit*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2024)				Chronology of Rating History for the Past 3 Years		
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating in FY2024	Date & Rating in FY2023	Date & Rating in FY2022	Date & Rating in FY2021
					Nov 27, 2023	Nov 30, 2022	Jan 3, 2022	Mar 30, 2021
1	**Basel III Tier II Bonds**	Long term	1,200.00	487.00^	**[ICRA]AA- (Stable)**	**[ICRA]A+ (Stable)**	**[ICRA]A (Positive)**	**[ICRA]A(hyb) (Stable)**
2	**Certificates of Deposit (CD)**	Short term	3,000.00	-	**[ICRA]A1+**	**[ICRA]A1+**	**[ICRA]A1+**	**[ICRA]A1+**

^Balance amount yet to be placed as of November 20, 2023

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

Complexity level of the rated instruments

Instrument	Complexity Indicator
Basel III Tier II Bonds	Highly Complex
Certificates of Deposit	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: Click Here

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon/Interest Rate (%)	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE036D08015	**Basel III Tier II Bonds**	Mar 12, 2019	11.95%	Jun 12, 2029	487.00	[ICRA]AA- (Stable)
Unplaced	**Basel III Tier II Bonds**	NA	NA	NA	713.00	[ICRA]AA- (Stable)
Unplaced	**Certificates of Deposit***	NA	NA	7-365 days	3,000.00	[ICRA]A1+

Source: KVB; CD outstanding as on November 20, 2023 was Nil

Key features of rated debt instruments

The servicing of the Basel III Tier II Bonds and certificates of deposit is not subject to any capital ratios and profitability. However, the Basel III Tier II Bonds are expected to absorb losses once the point of non-viability (PONV) trigger is invoked by the RBI. These bonds have equity-like loss-absorption features, which may translate into higher loss severity vis-à-vis conventional debt instruments.

Annexure II: List of entities considered for consolidated analysis – Not applicable

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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.

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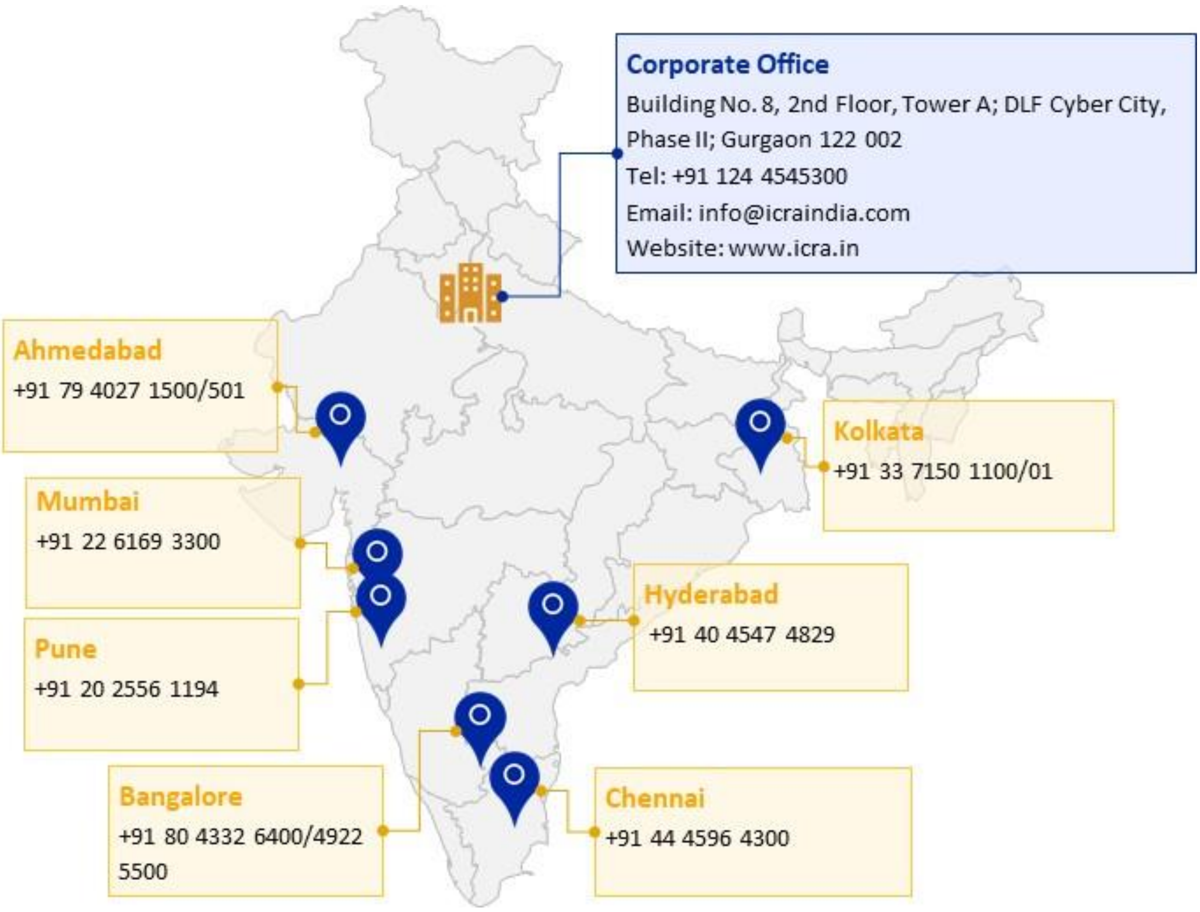

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