

March 17, 2020

## Uttarakhand Gramin Bank: [ICRA]BBB-(hyb)(Stable) assigned to perpetual bonds

### Summary of rating action

Instrument*	Current Rated Amount (Rs. crore)	Rating Action
Perpetual Debt Programme	300.00	[ICRA]BBB-(hyb)(Stable); Assigned
<b>Total</b>	<b>300.00</b>	

\*Instrument details are provided in Annexure-1

The rated Tier I Bonds have specific features, whereby the debt servicing is linked to the bank meeting the regulatory norms for capitalisation and reported profitability. As per the regulatory norms for these debt capital instruments, approval from the Reserve Bank of India (RBI) is required for debt servicing (including principal repayments) in case the bank reports a loss and is not liable to service the debt if it breaches the minimum regulatory capitalisation norms, i.e. CRAR of 9.0%. The coupon, if not paid, is non-cumulative.

### Rationale

The assigned rating takes into account the strong parentage of Uttarakhand Gramin Bank (UGB), held jointly by the Government of India (GoI; 50% holding), Government of Uttarakhand (GoU; 15%) and State Bank of India (SBI - 35%; rated [ICRA]AAA(Stable)). Further, UGB is incorporated under the Regional Rural Banks Act, 1976, under which dilution in the combined holding of the GoI and the sponsor bank (SBI) is limited to 51%, thereby ensuring sizeable direct or indirect sovereign ownership in UGB at all times. Moreover, regional rural banks (RRBs) remain strategically important to the GoI and state governments for meeting the credit demands of the agricultural sector.

The rating also factors in UGB's deposit profile, which remains inherently granular, given its rural presence as well as the high share of current account and savings account (CASA) in total deposits, which stood at 57% as on March 31, 2019, above the RRB average of ~54%. The high share of CASA, coupled with the granular term deposit base, kept the cost of interest-bearing funds low at 4.76%, below the RRB average in FY2019. Despite the lower cost of funds, UGB's weak capital position constrains its ability to improve the credit-deposit ratio, leading to subdued yields on assets and operating profitability. The weak asset quality metrics and high operating expenses resulted in a weak profitability profile for UGB with profit after tax (PAT)/average total assets (ATA) of 0.28% in FY2019 (0.07% in FY2018). UGB has a sizeable investment book (42% of total assets) in Government securities (G-Secs) because of the lower credit-to-deposit ratio. This, in turn, increases the sensitivity of the bank's profitability to movements in bond yields.

The rating also factors in UGB's large unprovided pension liabilities, in relation to its net worth, which stood at Rs. 311 crore (~153% of core equity capital – CET-I) as on March 31, 2019 and Rs. 220 crore as per the bank's assessment as on December 31, 2019. Given the size of the pension liability and the weak asset quality (NNPA of Rs. 70 crore as on March 31, 2019), the bank's solvency<sup>1</sup> profile is weak. Further, the capital adequacy ratio (CRAR) was marginally above the regulatory requirement of 9.0% at 9.5% (CET-I at 8.8%) as on March 31, 2019.

ICRA estimates that the bank's ability to provide for the pension liabilities through its operating profits remains limited as these liabilities need to be provided for by March 31, 2023 as per the regulatory requirements. As a result, the bank's internal capital generation will remain weak with a likelihood of losses unless it significantly scales up its operating

<sup>1</sup> Solvency is defined as (net NPA+ unprovided pension liability)/core equity  
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profits by scaling up the business for which it has limited capital cushions. Even with the proposed perpetual debt instrument (PDI) issuance, UGB will need to maintain a CET-I ratio of 5.5% to achieve the overall CRAR of 9.0%. This may be challenging if the bank pursues credit growth or if it reports losses in the absence of credit growth and given the requirement to provide for the pension liabilities.

The rating takes into account the focus on extending credit within a single state (Uttarakhand), thereby limiting the overall scale and growth prospects while keeping the geographical concentration of the loan book high. While the contribution of crop and agriculture loans to total net advances is low (19% of gross advances as on March 31, 2019), the overall contribution to the agri-allied segments remains sizeable. UGB remains vulnerable to agro-climatic risks, which could severely impact collections and lead to the deterioration of its asset quality metrics. Furthermore, given its focus on rural credit, UGB's product profile remains small with limited avenues to scale up the fee-based income, which largely remains restricted to cross selling of SBI insurance products.

## Key rating drivers and their description

### Credit strengths

**Strong parentage ensured under RRB Act** – UGB was incorporated under the Regional Rural Banks Act, 1976 and is jointly owned by the GoI (50% holding), GoU (15%) and SBI (35%). Legislative amendments introduced to the RRB Act in 2015 prevent the dilution in the combined holding of the GoI and the sponsor bank (SBI) below 51%, thereby ensuring sizeable direct or indirect sovereign ownership in UGB. Furthermore, under the Act, the GoI appoints the Chairman and two directors to the board, while the state government is represented by two nominee directors. SBI, on the other hand, is represented by two directors nominated by it. Additionally, the board has representatives from NABARD and the RBI as board members. SBI and NABARD closely monitor the operational and financial performance of RRBs and extend supervisory support on a periodic basis. However, ICRA notes that while SBI remains UGB's sponsor bank, any change in the sponsor bank, under a scheme of amalgamation, will remain a monitorable going forward.

**Deposit profile characterised by high share of CASA and granularity** – As on March 31, 2019, UGB had ~286 branches in the rural and semi-urban regions of Uttarakhand. The rating also factors in the bank's deposit profile, which remains inherently granular, given its rural presence as well as the high share of CASA, which stood at 57% as on March 31, 2019, (RRB average of ~54% as on March 31, 2019). The steady and strong CASA base, coupled with the granular term deposit base, helped maintain a low cost of interest-bearing funds at 4.76% in FY2019 (5.19% in FY2018), which also remained below the RRB average of 5.01%. However, this was also driven by the steady CASA deposit growth and the limited need to mobilise term deposits, given the low credit-deposit ratio. If the bank receives capital and pursues credit growth, the incremental deposit mobilisation through term deposits will reduce the share of CASA deposits and push up the cost of funds.

### Credit challenges

**Weak profitability; will continue to be weighed down by pension-related liabilities** – Despite the lower cost of funds, UGB's profitability profile remains relatively weak owing to the weak asset quality metrics (GNPA at 7.35% and NNPA at 3.21% as on March 31, 2019) and high operating expenses, mainly due to high employee costs and the constrained scale of operations resulting from the weak capital position. However, even though the credit-deposit ratio was low at 43.3% vis-à-vis the RRB average of 60.3% as on March 31, 2019, the bank reported healthy net interest margins (NIMs) in FY2019 (3.41% in FY2019 against 2.82% in FY2018), supported by the lower cost of funds. The operating expenses (2.72% of ATA in FY2019 vis-à-vis 2.39% in FY2018) were high as the asset base is not commensurate with the branch network. This has kept the pre-provision operating profit muted at 1.04% of ATA in FY2019 (0.78% in FY2018). The weak operating

profitability along with the higher credit costs of 0.85% (credit provision/ATA) against 0.31% in FY2018, kept the bank's return metrics weak with PAT/ATA at 0.28% in FY2019 against 0.07% in FY2018.

The bank had a total pension liability of Rs. 316 crore as per the actuarial valuation as on March 31, 2019, which needs to be provided for during FY2019-2023. Of this, UGB has provided Rs. 4.8 crore till March 31, 2019 while Rs. 311 crore has to be provided for till FY2023. As of March 31, 2019, the unprovided pension liabilities amounting to Rs. 311 crore were significantly high in relation to the core capital (~153%) and operating profit (operating profit was 0.15 times the total of the unprovided pension liability and NNPA). As of December 31, 2019, the bank has assessed these unprovided liabilities to be Rs. 220 crore which have to be provided till FY2023. In addition, the NNPA stood at Rs. 70 crore as on March 31, 2019.

ICRA estimates that the bank's ability to provide for the pension liabilities through its operating profits remains limited as these liabilities need to be provided for by March 31, 2023 as per the regulatory requirements. As a result, UGB's internal capital generation will remain weak with a likelihood of losses unless it significantly scales up its operating profits by scaling up the business for which it has limited capital cushions. Additionally, a sizeable investment book (42% of the total assets) in G-Secs increases the sensitivity of the bank's profitability to movements in bond yields.

**Thin capital cushion; large unprovided pension liabilities to impact capitalisation** – UGB's CRAR stood at 9.5% (CET-I at 8.8%) as on March 31, 2019 against the regulatory requirement of 9%<sup>2</sup> (CRAR). Given the thin capital cushions, UGB will remain dependent on capital support to provide for the pension liabilities and to significantly scale up its operating profits by scaling up the business. This is reflected by the high net leverage (net advances/net worth) of ~10.2 times as on March 31, 2019 in comparison to the RRBs' average of ~8.15 times. Going forward, even with the proposed PDI issuance, the bank will need to maintain a CET-I ratio of 5.5% to achieve the overall CRAR of 9.0%. This may be challenging if it pursues credit growth or if it reports losses in the absence of credit growth while providing for pension liabilities.

**High geographical concentration and vulnerability to agro-climatic risks translating into weak asset quality** – RRBs were set up with a primary focus on meeting the credit demand of the rural and agriculture sector, with a district-defined role for each RRB. As RRBs operate within a limited number of districts or a single state, their overall scale and growth prospects remain limited, resulting in high geographical concentration of the loan book. UGB's loan book remains relatively diversified with the share of agriculture loans, industries, services and personal loans at ~19%, 5%, 21% and 55%, respectively, of gross advances. However, a sizeable exposure to the agriculture sector or agri-allied industries, coupled with the marginal profile of the borrowers, exposes UGB to agro-climatic risks, which could severely impact collections and lead to the deterioration of its asset quality metrics. The high GNPA levels witnessed in the agriculture segment (GNPA at 21.49% as on March 31, 2019) led to continued weakness in the bank's overall asset quality metrics with GNPA and NNPA at 7.35% and 3.21%, respectively, as on March 31, 2019 against 8.39% and 5.47%, respectively, as on March 31, 2018.

**Limited diversity in products and earnings** – UGB's product profile primarily comprises agriculture loans and loans to MSMEs. The limited product profile and the absence of avenues to scale up the fee-based income restrict the scope for improvement in UGB's income profile. Further, the contribution of UGB's fee-based income stood at ~0.4 of ATA, which

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<sup>2</sup> The RRBs need to maintain a minimum Tier I capital of 7.0%, and within the overall Tier I capital, the PDIs are restricted to 1.5%. In case the bank meets the core equity capital (CET) requirement of 5.5% and Tier I of 7.0% with PDIs, any additional PDI over 1.5% is eligible for the calculation of the overall CRAR. Further, the RRBs are not allowed to issue Tier II instruments and the current Tier II capital consists of standard assets provisioning. Accordingly, even in a scenario where the RRBs are able to raise sizeable PDIs, their ability to meet the overall CRAR will continue to be driven by their ability to meet the minimum CET of 5.5%

was higher than the RRB average. However, this was generated largely by cross selling SBI insurance products, adjusted for which, the fee-based income profile remains weak.

### Liquidity position: Strong

UGB's advances mainly (~51% as on March 31, 2019) comprise short-term loans like crop loans with a tenure of less than 12 months. This, along with the high share of CASA deposits, helps maintain a well-matched asset liability profile. As per the structural liquidity statement for December 31, 2019, the bank had positive cumulative mismatches across all buckets up to 1 year. Moreover, because of the low credit-deposit ratio, UGB's statutory liquidity ratio (SLR) remains well above the regulatory requirement of 19%. The bank can also avail liquidity support from SBI in the form of overdraft facilities as well as refinance from NABARD or borrow from RBI (through repo against excess SLR investments and the marginal standing facility scheme) in case of urgent liquidity needs.

### Rating sensitivities

**Positive triggers** – ICRA could revise the outlook to Positive or upgrade the rating if UGB's profitability improves with an RoA of >0.5% coupled with an improvement in its solvency profile. An improvement in the scale of operations and the business risk profile, which is vulnerable to asset quality risks given the high share of agricultural advances, will also be a positive factor.

**Negative triggers** – ICRA could revise the outlook to Negative or downgrade the rating if there is a deterioration in the asset quality, leading to the erosion of the core capital, and/or if high credit growth without commensurate capital raising leads to the weakening of the capital cushions to less than 1% at the CET-I, Tier-I or CRAR levels on a sustained basis.

### Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	<a href="#">ICRA Rating Methodology for Banks</a> <a href="#">Impact of Parent or Group Support on an Issuer's Credit Rating</a>
Parent/Group Support	UGB was incorporated under the Regional Rural Banks Act, 1976 and is jointly owned by the GoI, GoU and SBI. RRBs remain strategically important to the GoI and state governments, with sizeable direct or indirect sovereign ownership ensured under the RRB Act, 1976 at all times. ICRA expects UGB to receive financial support from its co-owners, if required.
Consolidation/Standalone	To arrive at the rating, ICRA has considered the standalone financials of UGB

### About the company

Uttarakhand Gramin Bank (UGB) was established on November 1, 2012 when the erstwhile Uttaranchal Gramin Bank (sponsored by SBI) and Nainital Almora Khetriya Gramin Bank (sponsored by Bank of Baroda) were amalgamated into one entity. UGB's head office is in Dehradun. It has a network of 286 branches covering 13 districts in Uttarakhand.

UGB reported a profit after tax of Rs. 15 crore in FY2019 (PAT of Rs. 4 crore in FY2018) on a total asset base of Rs. 5,549 crore as on March 31, 2019 (Rs. 5,115 crore as on March 31, 2018), translating into an RoA of 0.28% (0.07% as on March 31, 2018). For 9M FY2020, the bank reported a net profit of Rs. 0.02 crore on a total asset base of Rs. 5,873 crore as on December 31, 2019.

## Key financial indicators (audited)

	FY2018	FY2019	9M FY2020*
Net interest income	138	182	136
Profit before tax	4	21	0.02
Profit after tax	4	15	0.02
Net advances	2,045	2,168	2,217
Total assets	5,115	5,549	5,873
% CET I	8.6%	8.8%	8.6%
% Tier I	8.6%	8.8%	8.6%
% CRAR	8.9%	9.5%	9.2%
% Net interest margin	2.82%	3.41%	3.17%
% PAT / ATA	0.07%	0.28%	0.00%
% Return on net worth	1.87%	6.99%	0.01%
% Gross NPAs	8.39%	7.35%	9.99%
% Net NPAs	5.47%	3.21%	5.41%
% Provision coverage excl. technical write-offs	36.9%	58.2%	48.4%
% Net NPA/ CET	59.2%	34.2%	59.0%

Note: Amount in Rs. crore; Net worth and total assets exclude revaluation reserves

Source: UGB, ICRA research

\*9M FY2020 results are unaudited

All calculations are as per ICRA research

## Status of non-cooperation with previous CRA: Not applicable

## Any other information: None

## Rating history for past three years

Instrument	Type	Amount Rated	Amount O/S	Rating (FY2020)	Rating History for the Past 3 Years		
				Current Rating Mar-17-2020	FY2019	FY2018	FY2017
Perpetual Debt	LT	300.00	0.00	[ICRA]BBB-(hyb)(Stable); Assigned	-	-	-

Amount in Rs. crore

## 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](http://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
-	Perpetual Debt	-	-	-	300.00 <sup>#</sup>	[ICRA]BBB-(hyb)(Stable)

<sup>#</sup> Yet to be issued

Source: UGB

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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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