February 10, 2020

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 Compliant 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
Lower Tier II Bonds Programme	300.00	-	[ICRA]A (Stable); withdrawn
Total	**4,500.00**	**4,200.00**	

**Instrument details are provided in Annexure-1*

The letters, hyb, in parenthesis, suffixed to a rating symbol stand for hybrid and indicate 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 are expected to absorb losses once the point of non-viability (PONV) trigger is invoked.

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 14.1% in December 2019) and the strong liquidity profile (liquidity coverage ratio of 306% in December 2019). The ratings also factor in steady improvement in the deposit profile, with current accounts and savings account (CASA) increasing to 31% of the total deposits as of December 2019 (30% in March 2019) from 23% in March 2016. The rating, however, considers the elevated level of fresh slippages (3.6% for 9MFY2020) and gross non-performing assets (8.9% as of December 2019 vis-à-vis 8.8% as of March 2019). The slippages were primarily in the corporate and commercial[1] segments (together constituted 59% of gross advances as of December 2019) thereby driving subdued profitability because of high provisions. The modest scale and geographically concentrated nature of operations also remain as constraining factors. Since FY2019, the bank has implemented various measures, including centralization of credit across the retail and commercial segments, and focus on digital applications to underwrite credit. While these measures have resulted in improvement in asset quality of the newer vintage loans, its critical to sustain the performance besides undertaking effective recoveries to improve the asset quality, and the same would be key rating monitorable.

ICRA also notes that KVB has been granularizing its book with increasing focus on the retail and commercial segments, while it is selective in lending to the corporate segment. As a result, the share of corporate segment declined to 26.4% of the gross advances as of December 2019 from 28.3% as of December 2018 while the share of retail segment increased to 23.7% as of December 2019 from 19.3% as of December 2018; the share of commercial and agriculture stood at 32.7%and 17.2% respectively, as of December 2019. Overall, gross advances grew by a modest 4% YoY to Rs. 49,613 crore as of December 2019. The bank may not require any external capital to achieve a compounded annual growth rate (CAGR) of 10-12% over the period FY2020-2022 while maintaining sufficient cushion above the regulatory capital requirement[2].

[1] *Exposure to MSME segment with outstanding below Rs.25 crore*

[2] *Minimum Tier I capital requirement including capital conservation buffer (CCB) will be 9.5%, while total capital including CCB will be 11.5% from March 31, 2020*

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 779 as of December 2019, of which 84% was in Tamil Nadu, Andhra Pradesh, Telengana and Karnataka. By virtue of the long operating history and deep-rooted presence in the Southern States, the bank has been able to build a granular retail franchisee with limited dependence on wholesale deposits. As of December 2019, the share of top 20 depositors, and share of bulk deposits (above Rs.5 crore) was low at about 6% of overall deposits, compared to other banks of similar size amongst the private banks. Further, while the cost of interest-bearing funds is marginally higher than the private banking average, the spread has declined over the years, underscoring its ability to mobilize deposits at competitive interest rates.

Adequate capitalization – KVB has an adequate capitalization, with CET-I[3] and CRAR of 14.1% and 15.9%, respectively, as of December 2019 (14.3% and 16.0%, respectively, as of March 2019) as compared to 13.9% and 14.4% as of March 2018, respectively. The improvement in capitalization was supported by Rs.892 crore equity infusion during Q3FY2018 via a rights issue, while risk weighted assets (RWA) remained broadly flat over the last two years. The bank may not need capital to achieve a CAGR of 10-12% over FY2020-FY2022, to maintain a buffer of 2% over the Tier-1 regulatory requirement, even as the internal generation is expected to remain subdued because of higher provision requirement.

Increasing focus on granular retail assets to aid portfolio diversification - ICRA takes note of the bank' focus on building granular asset book and reducing large ticket exposure. The share of corporate loans reduced to 26.4% of gross advances as of December 2019 (28.0% as of March 2019) from 32.9% in March 2017 while the retail segment grew to 23.7% as of December 2019 (22.3% as of March 2019) from 15.3% as of March 2017. Further, the top 20 exposure declined to 7% of gross advances as of December 2019 (7% as of March 2019) from 10% as of March 2017. With increasing granularization of the loan book, the growth in RWA 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

Continued slippages in the corporate and commercial segment exert pressure on the asset quality profile - KVB's asset quality remain weak with gross NPAs of 8.9% in December 2019 vis-à-vis 8.8% in March 2019 (3.6% in March 2017), which is high compared to private sector bank' average. The gross NPA in the corporate and commercial segment stood at 22.2% and 6.6% respectively, in December 2019 vis-à-vis 21.6% and 6.3% respectively, in March 2019; these segments together constituted 59% of gross advances in December 2019. Exposure to certain vulnerable borrower segments such as infrastructure (including power) and certain non-banking financial institutions, and the concentration of such exposures have been an inherent risk, reflected in the high level of NPAs; NPAs with ticket size of more than Rs. 100 crore constituted one-third of overall NPAs as of September 2019.

KVB' fresh slippages increased to 5.2% in FY2019 (5.1% in FY2018) from 3.4% in FY2017; though it subsided to 3.6% (annualized) in 9MFY2020. Overall SMA 1&2 declined to 3.2% in December 2019 (about 3.6% in March 2019) from 9.1% in March 2017. With the stress emerging from the commercial segment, because of the impact of the ongoing economic slowdown, and presence of some residual stressed exposures in the corporate book, where the SMA 1&2 stood at 1.0% in December 2019 (0.6% in March 2019), fresh slippages are likely to persist in the near term, though it is expected to be lower than the level seen in FY2019. The bank' standard restructured advances[4] increased to 0.4% of standard advances in December 2019 from 0.1% in March 2019 driven by MSME restructuring. Further, the bank' unprovided security receipts stood at about 1% of standard advances in December 2019. Overall, the Net NPA (including the unprovided SRs

[3] *Core equity capital does not include the profits earned during the 9M period*

[4] *Forbearance window for restructuring MSME loans available till March 2020*

and restructured advances) remain elevated at 3.6% in December 2019 (4.2% in March 2019) compared to 3.8% in March 2018. Continued slippages in the corporate segment and restructuring of MSME loans would remain an overhang on the overall asset quality and the same would be a rating monitorable.

The bank's solvency profile (net NPA/ core equity) weakened to 38.8% in March 2019 (30.3% in March 2018) from 21.6% in March 2017, before improving to 31.3% in December 2019, because of the sale of few non-performing accounts to asset-reconstruction companies. Including SRs, the unprovided stress exposure stood at 39.7% of core equity capital. ICRA notes that the bank is focusing on relatively smaller ticket loans in the commercial and retail segments while it is limiting exposure to the corporate segment. Further, the bank took measures to strengthen its internal controls including centralizing its credit operations. It has implemented digital workflow across its loan products (across retail and commercial segments), which is operational since FY2019. While these measures have resulted in some improvement in performance of the newer vintage loans, its ability to sustain the trend over a relatively longer time frame remains to be seen. Overall, the bank's ability to contain incremental slippages and undertake effective recoveries would be key from a rating perspective.

High credit provisions to remain an overhang on profitability – KVB's net interest margin remained broadly stable at 3.5% of average total assets (ATA) in FY2019 (3.3% in 9MFY2020) compared to prior three-year average of 3.4% (FY2016-2018), in line with the private bank' average. Apart from the interest rate easing cycle, the substantially high level of treasury assets and the contraction in performing assets impacted its yield on earning assets, though the impact on margins was limited given the benign cost of interest-bearing funds. The bank' core operating profitability, nevertheless declined to 2.4% of ATA in FY2019 (2.0% in 9MFY2020) from 2.6% in FY2018, as operating expenses have increased during the period. Further, the bank' credit provisions, have also sharply increased to 1.9% of ATA in FY2019 and remain elevated at 2.0% in 9MFY2020 vis-à-vis 1.6% in FY2018 (0.7% in FY2017), due to build up in NPAs and higher provisioning for ageing NPAs. The bank' provision coverage[5] increased to 56% in December 2019 from 45.6% in March 2019 (38.2% in March 2018). Overall, the net profitability, declined to 0.3% of ATA in FY2019 (0.3% in 9MFY2020) from 0.5% in FY2018 (1% in FY2017) which is lower than the private bank' average. Going forward, given the elevated level of net NPAs, the bank would have to make incremental provisions if recoveries are delayed or fall short of expectation, and the same would translate in below average profitability. As per ICRA's estimates, the credit provisions for FY2020 and FY2021 are estimated to remain elevated at 2.5-2.7% and 1.9-2.2%, which will translate into below average profitability with RoA of 0.2-0.3% and 0.5-0.6% for FY2020 and FY2021, respectively.

Moderate scale and geographically concentrated operations – KVB's net advances and deposits stood at Rs. 47,119 crore and Rs. 62,262 crore, respectively, in December 2019 accounting for about 0.5% each, of the banking sector's. The bank' business growth has been subdued in the recent past, as it is in a period of consolidation; its advances and deposits grew at a CAGR of 7.5% and 6.1%, respectively, during April 2016-March 2019 compared to the private sector banks' growth of 18.2% and 17.9%, respectively (6.7% and 8.3%, respectively, for the overall banking sector) during this period. In line with its concentrated branch presence, about 50% of the advances were from Tamil Nadu in September 2019. ICRA expects the bank's operations to remain modest and regionally concentrated going forward.

Liquidity position: Strong

The bank's liquidity coverage ratio (LCR) remained high at 306% in Q3FY2020 against the regulatory requirement of 100% as on January 1, 2019. KVB' LCR has been significantly higher than its peers in the private bank sector, due to excess holding in government securities and limited near-term outflows, stemming from higher share of stable deposits (rollover of term deposits at about 80%) and low share of non-operational deposits.

As per the structural liquidity statement for September 30, 2019, the bank has positive mismatches (inflows higher than outflows) across all the buckets in the less than 1-year segment. Going forward, KVB's ability to expand its deposit base and maintain high renewals will remain key for liquidity while achieving the stated growth. On a fortnightly average

[5] *(Gross NPA- Net NPA)/Gross NPA*

basis, the bank maintained an excess SLR holding of more than 250 bps of the net demand and time liabilities as of March 2019 (300 bps as of September 2019). The excess SLR holding above the regulatory levels can be utilised to avail liquidity support from the RBI (through repo) apart from the marginal standing facility of the RBI in case of urgent liquidity needs.

Rating sensitivities

Positive triggers – ICRA could upgrade the ratings or revise the outlook to Positive 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 NPA/ 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 RoA of > 1.0% on a sustained basis would also be rating trigger.

Negative triggers – 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 Net NPA / Core equity, with requisite capital cushion of at least 2% over regulatory levels, remaining above 35% for a prolonged period.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Rating Methodology for Banks ICRA's Policy on Withdrawal of Rating
Parent/Group Support	Not applicable
Consolidation/Standalone	The rating is based on the standalone financial statements 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. As on December 31, 2019, it had a network of 779 branches with south India constituting 84% of the total branches. The bank' gross advances stood at Rs. 49,613 crore as of December 2019, with presence in corporate, commercial, retail and agriculture segments. During FY2018, the bank embarked on a business model transformation to centralize its credit functions. During the current fiscal, it took a strategic initiative 'KVB Neo' to enable business growth by leveraging technology and partnering with fintech companies.

For FY2019, KVB registered net profit of Rs. 211 crore (Rs. 346 crore in FY2018) on a total asset base of Rs. 69,340 crore as on March 31, 2019 (Rs. 66,929 crore as on March 31, 2018).

Key financial indicators (audited)

	FY2018	FY2019	9MFY2019 (unaudited)	9MFY2020 (unaudited)
Net Interest Income	2,298	2,363	1,744	1,757
Profit before tax	504	322	210	202
Profit after tax	346	211	151	151
Net advances	44,800	48,581	46,005	47,119
Total assets (net of revaluation reserve)	66,929	69,340	67,590	72,655
%CET-1	13.9%	14.3%	14.1%	14.1%
%Tier 1	13.9%	14.3%	14.1%	14.1%
%CRAR	14.4%	16.0%	14.6%	15.9%
%Net Interest Margin	3.6%	3.5%	3.5%	3.3%
%Net Profit / ATA	0.5%	0.3%	0.3%	0.3%
%Return on Average Net Worth	6.1%	3.3%	3.2%	3.1%
% Gross NPAs	6.6%	8.8%	8.5%	8.9%
% Net NPAs	4.2%	5.0%	5.0%	4.1%
% Provision coverage excl. technical write off	38.2%	45.6%	43.4%	56.0%
% Net NPA/ Core Equity	30.3%	38.8%	37.6%	31.3%

Source: KVB and ICRA research; Amounts in Rs. crore

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2020)				Rating History for the Past 3 Years				
		Type	Amount Rated	Amount Outstanding	Rating	FY2019			FY2018	FY2017
					10-Feb-2020	22-Feb-2019	11-Jan-2019	30-Aug-2018	13-Jul-2017	3-May-2016
1	Basel III compliant Tier II Bonds	Long Term	1,200.00	1,200.00	[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)	[ICRA]A+ (stable)
3	Certificates of Deposit Programme	Short Term	3,000.00	3,000.00	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

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

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE036D09013	Lower Tier II Bonds Programme	25-Sep-2009	9.86%	25-Sep-2019	150.00	[ICRA]A (Stable); withdrawn
NA	Lower Tier II Bonds Programme	-	-	-	150.00	[ICRA]A (Stable); withdrawn
INE036D08015	Basel III compliant Tier II Bonds	12-Mar-2019	11.95%	12-Jun-2029	487.00	[ICRA]A (hyb) (Stable)
NA#	Basel III compliant Tier II Bonds	NA	NA	NA	713.00	[ICRA]A (hyb) (Stable)
NA	Certificates of Deposit Programme	-	-	-	3,000.00	[ICRA]A1+

 # Yet to be placed; Source: KVB

Annexure-2: 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.

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.

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