March 09, 2020

The Jammu and Kashmir Bank Ltd: [ICRA]A+(hyb)(Stable) assigned to Basel III Tier II bonds

Summary of rating action

Instrument*	Current Rated Amount (Rs. crore)	Rating Action
Basel III Compliant Tier II Bonds Programme	1,050.00	[ICRA]A+ (hyb) (Stable); *Assigned*
Total	**1,050.00**	

**Instrument details are provided in Annexure-1*

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.

Rationale

The rating assigned to the Basel III tier II bonds of The Jammu and Kashmir Bank Ltd (JKB) factors in the high strategic importance of the bank in the Union Territories (UTs) of Jammu & Kashmir (J&K) and Ladakh, demonstrated by its high share in the overall banking business in these UTs. Moreover, with the majority ownership of the Government of Jammu & Kashmir (GoJK) and its high strategic importance to the GoJK, the bank has witnessed requisite capital support from the GoJK in the past and a capital infusion of Rs. 500 crore has also been announced for the current fiscal (FY2020). The rating also factors in JKB's strong resource profile with a high share of low-cost deposits (translating into a low cost of funds vis-à-vis the sector average), driving a strong liquidity profile for the bank.

The rating, however, remains constrained by JKB's weak asset quality profile, with high slippages in the past because of a deterioration in the asset quality of the corporate book and due to retail slippages on account of natural calamities and unrest in the J&K region. The slippages remained high in 9M FY2020 as well with an annualised fresh slippage rate of 7.0% compared to 5.5% in FY2019, resulting in an increase in the stock of gross non-performing assets (NPAs). The spike in slippages in 9M FY2020 can be attributed to the abrogation of Article 370 in August 2019, which impacted business activities in J&K and Ladakh (62% of the bank's total advances were from the J&K and Ladakh book, as on December 31, 2019). The stress on the asset quality may continue for the bank in the near term, given the high share of SMA[1] advances, and its ability to control slippages will remain critical for its earnings profile. The divergence in NPA provisioning and high slippages resulted in losses in 9M FY2020, leading to a weak solvency profile with net NPA/core equity capital of 52.5%, as on December 31, 2019. Moreover, the capital cushions have moderated compared to the regulatory levels with the CET I and Tier I capital at 8.15% and 9.66%, respectively, as on December 31, 2019 against the regulatory requirement of 8.0% and 9.5%, respectively, from March 31, 2020.

Going forward, despite the announced capital infusion, ICRA expects JKB's capital requirement to remain sizeable at Rs. ~1,200-1,500 crore of Tier I capital (~130-160% of current market capitalisation) to support growth and improve the capital cushions. The bank expects the monetisation of non-core investments and improved internal capital generation with RoA of 0.5-0.6% in FY2021, apart from the reversal of provisions on certain stressed exposures in the near term. The

[1] SMA stands for special mention account and is bucketed into three categories – SMA0 (overdue by 1-30 days), SMA1 (overdue by 31-60 days) and SMA2 (overdue by 61-90 days)

ability to achieve these parameters and the size of capital raising in FY2021 will remain the key drivers of JKB's capitalisation and solvency profile and key rating sensitivities.

Key rating drivers and their description

Credit strengths

Strategic importance in the UTs of J&K and Ladakh – JKB is a relatively small-sized bank in the Indian banking system with less than 1% market share in advances and deposits as on December 31, 2019. However, it has high strategic importance to the GoJK, given its dominant market position in the UTs of J&K and Ladakh. Moreover, it is the only private sector bank designated as the Reserve Bank of India's (RBI) agent for banking business and carries out the banking business for the UTs of J&K and Ladakh. The GoJK has majority ownership in the bank, accounting for 59.23% of the equity stake as on December 31, 2019, which will further increase to ~68% after the announced capital infusion for FY2020. The bank has received capital support from the GoJK in the past with capital infusions of Rs. 250 crore in FY2017 and Rs. 282 crore in FY2018, while a capital infusion of Rs. 500 crore has been announced for the current fiscal (FY2020). Thus, by virtue of its strategic importance, ICRA expects JKB to receive capital support from the GoJK in future, if required.

Established retail franchise, with strong presence in UTs of J&K and Ladakh, supports steady deposit profile – JKB has an established retail franchise with a strong regional focus in the UTs of J&K and Ladakh, as depicted by its network of 955 branches (~86% in J&K and Ladakh) and 1,349 ATMs (~92% in J&K and Ladakh) as on December 31, 2019. Supported by this significant and deep regional presence (>50% branches in rural areas), the bank's deposit profile remains strong with a high share of low-cost current account and savings account (CASA) deposits. JKB's CASA deposits grew ~14.0% YoY to Rs. 48,018 crore as on December 31, 2019, driving the overall YoY growth of ~8.1% in total deposits. Within term deposits, 62% are less than Rs. 1 crore, thereby imparting granularity to the liability profile. The overall CASA and deposits of less than Rs. 1 crore accounted for ~80.5% of the bank's overall deposit base as on December 31, 2019. With higher growth in the CASA base vis-à-vis the overall deposits, the CASA share improved to 51.5% as on December 31, 2019 from 48.9% as on December 31, 2018 and was better than the average CASA share in the banking system. The top 20 depositors accounting for 11.8% of the total deposits as on March 31, 2019 compared to 14.3% as on March 31, 2018. However, most of these were various government departments.

A high CASA share translates into a low cost of funds for the bank compared to the sector average. JKB's cost of interest-bearing funds stood at 5.10% compared to 5.25% for the banking sector in 6M FY2020, which also supports its net interest margins (NIMs).

Credit challenges

Weak asset quality profile – Due to the continued stress in its corporate loan book and slippages on account of the abrogation of Article 370, which affected business activities in J&K and Ladakh, JKB reported high fresh slippages of Rs. 3,289 crore in 9M FY2020 (annualised slippage rate of ~7.0%) compared to Rs. 2,965 crore in FY2019 (~5.5%). Of the Rs. 3,289 crore of slippages in 9M FY2020, the slippages in Q2FY2020 stood at Rs. 1,958 crore. With the situation improving in subsequent months, the bank was able to upgrade advances of Rs. 435 crore in Q3 FY2020. It also upgraded the standard restructured accounts, totalling Rs. 1,985 crore in 9M FY2020, and the residual standard restructured accounts stood at Rs. 891 crore (1.4% of standard advances) as on December 31, 2019. These accounts were previously restructured under the RBI's dispensation on loan accounts that were impacted by the flash floods in J&K in September 2014 and unrest. Despite the improved upgradations, the high slippages resulted in an increase in the bank's gross NPA to Rs. 7,712 crore (11.10%) as on December 31, 2019 from Rs. 6,221 crore (8.97%) as on March 31, 2019.

As a part of its annual risk supervision report, JKB reported a divergence in its provisioning level of Rs. 884 crore on its stressed assets exposures as on March 31, 2019, which was accounted by the bank in its 9M FY2020 financials. As a result, its credit provisions stood elevated but resulted in an increased provision coverage ratio (PCR), excluding technical write-offs, of 63.56% as on December 31, 2019 compared to 47.93% as on March 31, 2019. Thus, the higher provision cover offset the increase in the gross NPA, resulting in a decline in the net NPA to Rs. 2,810 crore (4.36%) as on December 31, 2019 from Rs. 3,240 crore (4.89%) as on March 31, 2019.

Despite the high slippages, the bank's SMA 1 and 2 book outstanding remained sizeable at Rs. 5,200 crore (8% of standard advances) and Rs. 7,333 crore (12%), respectively, as on December 31, 2019. This was partially due to a few exposures being classified as SMA because of technical reasons following the unrest in August 2019. Even adjusting for such technically overdue exposures, the SMA book (SMA 1 and 2) remained sizeable at 13.9% of advances as on December 31, 2019 and represents a source of slippages going forward.

Weak earnings profile – The standard advances remained stable on a YoY basis as on December 31, 2019. However, the net interest income (NII) increased 10% YoY to Rs. 2,719 crore as on December 31, 2019 from Rs. 2,452 crore as on December 31, 2018 because of a change in the loan mix with an increased share of the higher-yielding retail book (personal loans) and a decline in the corporate book. Supported by the competitive cost of funds, the NIMs remained strong and with growth in the NII, the NIMs[2] inched up to 3.56% in 9M FY2020 from 3.50% in 9M FY2019. Notwithstanding the strong NIMs, the bank's operating profitability was weighed down by the high operating expenses (vis-à-vis private banks (PVBs)) and the low contribution from non-interest income sources. The operating expenses have remained high due to the provisions made for employee wage revision and branch expansion. The bank's operating profitability remains weak with operating profits/ATA of 1.41% for 9M FY2020 against 1.60% for 9M FY2019.

High slippages and the incorporation of the divergence in NPA provisioning spiked the credit costs to 2.65% of ATA in 9M FY2020 from 0.95% in 9M FY2019, thereby translating into a net loss of Rs. 845 crore (annualised RoA of -1.11%) compared to a net profit of Rs. 465 crore (RoA of 0.49%) in FY2019. The credit provisions of Rs. 2,022 crore (2.65% of ATA) surpassed the operating profits (1.41% of ATA) in 9M FY2020.

The management has guided towards credit costs of 0.7-0.9% of ATA (because of lower expected slippages), which will translate into an RoA of 0.5-0.6% for FY2021. However, the ability to maintain low slippages will remain a key driver for achieving the above guidance.

Weak capital cushions and large capital requirements – JKB's capitalisation profile weakened due to the losses in 9M FY2020, with its capital metrics, i.e. CET% and Tier I%, declining to 8.15% and 9.66%, respectively, as on December 31, 2019 from 9.13% and 10.60%, respectively, as on March 31, 2019. While its risk-weighted assets (RWA) moderated in 9M FY2020 (largely because of a decline in the corporate book), the losses led to a decline in the bank's core equity capital base, which led to erosion in the cushions over the regulatory capital requirements[3].

The weak capital cushions and high net NPA levels also led to a weak solvency profile with net NPA/core equity of 52.5% as on December 31, 2019 against 52.1% as on March 31, 2019 and 50.4% as on December 31, 2018.

Supported by a capital infusion in Q4 FY2020 and proposed divestments, the core equity capital is likely to improve in the near term though the solvency levels and capital cushions will remain weak. ICRA expects JKB to require Rs. ~1,200-1,500 crore of Tier I capital (~130-160% of current market capitalisation) to support growth and to maintain a 2% cushion over

[2] NIM = Net Interest Income/ Average Total Assets

[3] Minimum regulatory CET I, Tier I and CRAR stood at 7.375%, 8.875% and 10.875%, respectively, as on March 31, 2019; with the capital conservation buffer (CCB) increasing to 2.50% from 1.875% effective March 31, 2020, the regulatory CET I, Tier I and CRAR requirements will be 8.0%, 9.5% and 11.5%, respectively, as on March 31, 2020

the regulatory levels. Given the large capital requirement, the timely monetisation of the non-core investments, the extent of capital support from the GoJK and the level of internal capital generation will remain key for an improvement in the bank's capitalisation and solvency profile.

High regional concentration – As indicated earlier, the bank has a strong regional focus in the UTs of J&K and Ladakh, with 90% of its total deposits and 62% of its advances emanating from these two regions at the end of 9M FY2020. Thus, given the high geographical concentration of its banking business in J&K and Ladakh, any unrest or administrative instability in these UTs will impact the bank's asset quality and hence its credit profile.

Liquidity position – Strong

The structural liquidity statement (SLS) as on December 31, 2019 indicates a favourable mismatch with a cumulative mismatch of ~4.9% (as a percentage of total outflows) in the up to 1-year bucket. Moreover, as JKB's credit growth has remained muted, it has been maintaining large excess SLR investments. On a fortnightly average basis, the bank had excess SLR holdings of Rs. 4,397 crore (~4.7% of average net demand and time liabilities) during August 2019-January 2020. This has, in turn, supported the bank's strong liquidity coverage ratio (LCR) with an LCR of 262.22% as on December 31, 2019. ICRA expects the bank's retail liability franchise to support its deposit rollover and drive liquidity. Furthermore, JKB can avail liquidity support from the RBI (through reverse repo against excess SLR investments and the marginal standing facility) for urgent liquidity needs.

Rating sensitivities

Positive triggers – ICRA could change the rating outlook to Positive or upgrade the rating if the bank is able to improve its solvency with net NPA/core equity of < 30% and a capital cushion of over 2% at the Tier I level. Moreover, JKB will need to demonstrate a reduction in its slippage rate and improve its internal capital generation with an RoA of >1.0% on a sustained basis.

Negative triggers – ICRA could revise the outlook to Negative or downgrade the rating if the slippage rate remains high and the bank's RoA remains weak with sustained losses, which are not sufficiently offset by capital infusion, leading to a decline in the business and/or breach of the regulatory capital ratios.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA Rating Methodology for Banks
Parent/Group Support	-
Consolidation/Standalone	To arrive at the rating, ICRA has considered the standalone financials of JKB

About the company

The Jammu and Kashmir Bank Ltd (JKB) is a private sector scheduled commercial bank, incorporated on October 1, 1938, with its registered office in Srinagar (Jammu & Kashmir). As on December 31, 2019 the Government of Jammu & Kashmir (GoJK) was the majority shareholder in the bank, accounting for 59.23% of the equity shares.

For 9M FY2020, the bank reported a net loss of Rs. 845 crore on a total asset base of Rs. 1.03 lakh crore (excluding revaluation reserves) as on December 31, 2019 compared to a net profit of Rs. 250 crore in 9M FY2019 on a total asset base (excluding revaluation reserves) of Rs. 0.98 lakh crore as on December 31, 2018. JKB's gross and net NPA% stood at 11.10% and 4.36%, respectively, as on December 31, 2019 compared to 9.94% and 4.69%, respectively, as on December

31, 2018. It reported a Tier I capital ratio and CRAR of 9.66% and 11.09%, respectively, as on December 31, 2019 compared to 9.83% and 11.63%, respectively, as on December 31, 2018.

Key financial indicators (audited) – The Jammu and Kashmir Bank Ltd

	FY2018	FY2019	9M FY2019	9M FY2020
Net interest income	2,871	3,384	2,452	2,719
Profit before tax	359	660	437	-861
Profit after tax	203	465	250	-845
Net advances	56,913	66,272	65,027	64,488
Total assets	89,067	1,00,801	97,733	1,02,987
% CET I	9.24%	9.13%	8.38%	8.15%
% Tier I	9.24%	10.60%	9.83%	9.66%
% CRAR	11.42%	12.46%	11.63%	11.09%
% Net interest margin	3.36%	3.56%	3.50%	3.56%
% PAT / ATA	0.24%	0.49%	0.36%	-1.11%
% Return on net worth	3.61%	8.04%	5.88%	-20.12%
% Gross NPAs	9.96%	8.97%	9.94%	11.10%
% Net NPAs	4.90%	4.89%	4.69%	4.36%
% Provision coverage excl. technical write-offs	53.53%	47.93%	55.55%	63.56%
% Net NPA/ CET	48.13%	52.14%	50.40%	52.54%

Note: Amount in Rs. crore; Net worth and total assets exclude revaluation reserves
Source: JKB, ICRA research
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) Current Rating 09-Mar-2020	Rating History for the Past 3 Years FY2019 -	FY2018 -	FY2017 -
Tier II Bonds – Basel III	LT	1,050.00	0.00	[ICRA]A+ (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

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
-	Tier II Bonds - Basel III	-	-	-	1,050.00[#]	[ICRA]A+ (hyb) (Stable)

[#] Yet to be issued

Source: JKB

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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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