January 03, 2022

The Karur Vysya Bank Limited: Ratings reaffirmed; Outlook revised to Positive

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]A (Positive); Reaffirmed and outlook revised to Positive from Stable
Certificates of Deposit Programme	3,000.00	3,000.00	[ICRA]A1+; reaffirmed
Total	**4,200.00**	**4,200.00**	

**Instrument details are provided in Annexure-1*

Rationale

The ratings reaffirmation factors in The Karur Vysya Bank Limited's (KVB) established retail franchise in South India resulting in a granular asset and liability base, its comfortable capitalisation (CET I ratio of 16.79% in September 2021) and strong liquidity profile. The revision in the outlook on the long-term rating to Positive factors in the steady improvement in the bank's capital position and solvency[1] profile, which is likely to sustain and is expected to improve the internal capital generation, going forward. The headline asset quality indicators, i.e. gross non-performing advances (GNPAs) and net non-performing advances (NNPAs), have improved from previous levels and stood at 7.38% and 2.99%, respectively, as on September 30, 2021 (8.79% and 4.98%, respectively, as on March 31, 2019).

The ratings remain constrained by high operating expenses vis-à-vis the private banks (PVBs) average and the lower share of non-interest income (NOI) remains a drag on KVB's overall profitability. The ratings are also constrained by the high regional concentration of KVB's operations, which exposes its assets and liabilities to local socio-economic and political risks. The bank's ability to reduce the overall stressed loan book (SMA[2]-1 and 2 advances, standard restructured advances and NNPAs), given the uncertainty surrounding the resurgence in Covid-19 infections, will be critical for sustaining its profitability and capital ratios.

ICRA expects that the bank will maintain a comfortable capital position with further improvement in its asset quality and internal capital generation, thereby driving the Positive outlook on the rating.

Key rating drivers and their description

Credit strengths

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. The bank's branch network stood at 781 as on September 30, 2021, of which 86% was in the southern states of Tamil Nadu, Andhra Pradesh, Telangana, Kerala and Karnataka. However, as KVB was in a consolidation phase because of the asset quality issues faced in the recent past, the total branches declined from 799 as on March 31, 2018. The bank has a granular asset profile with the top 20 exposures accounting for 55.37% of the Tier I capital as on March 31, 2021, down from 66.52% as on March 31, 2020, supported by internal accruals and a decline in the top counterparties exposure, which remains at the lower end among peers. The bank's deposit base remains granular with limited

[1] Solvency 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

dependence on wholesale deposits. Term deposits of Rs. 1 crore and less comprised 84-86% of the total term deposits over the last few years and the top 20 depositors accounted for only 6.15% of total deposits as on March 31, 2021, which was lower than its peers.

While KVB's current account and savings account (CASA) ratio increased to 35.41% as on September 30, 2021 from 33.86% as on September 30, 2020 and remains at the higher end among peers, it is lower than the PVBs' average. As a result, KVB's cost of average interest-bearing funds remained high at 4.40% in H1 FY2022 (4.92% in FY2021) compared to the PVBs' average of 4.00% in H1 FY2022 (4.48% in FY2021) on account of the relatively lower share of CASA deposits in its overall deposit base.

Comfortable capitalisation profile – The bank has a comfortable capitalisation profile with a CET I ratio of 16.79% as on September 30, 2021 compared to 16.35% as on September 30, 2020.

Despite the modest internal capital generation during the last few years (return on equity (RoE) of 7.73% in H1 FY2022 and 5.16% in FY2021), the bank improved its capital ratios through the rationalisation of its risk-weighted assets (RWAs). Incremental loan disbursements under the Government-guaranteed Emergency Credit Line Guarantee Scheme (ECLGS) and gold loans, which attract zero risk weight, have reduced the RWAs for the bank during the last few years. ICRA expects KVB to remain self-sufficient to achieve a growth of ~9% over the next couple of years while maintaining the Tier I capital cushion above the negative triggers and improving its solvency profile.

Credit challenges

Improving solvency profile, but remains monitorable on account of high overall stressed assets – Despite the Covid-19 pandemic, the headline asset quality numbers improved since March 2020 on the back of various regulatory/policy measures such as moratorium on loan repayments for borrowers, liquidity enhancement through the ECLGS and one-time restructuring of loans. Further, the bank has increased the provision cover on its past stressed assets and reduced the NNPAs to 2.99% as on September 30, 2021 from the peak of 4.98% as on March 31, 2019. Accordingly, its solvency profile improved from past levels and stood at 26.71% as on September 30, 2021 (44.51% as on March 31, 2019). The management has guided for further reduction in the NNPAs to ~2.00% by March 2022.

Notwithstanding the reduction in the NNPAs, the standard restructured book (after including restructuring invoked but yet to be implemented) stood at 3.67% of standard advances as on September 30, 2021. The SMA 1+2 levels for the bank have reduced by ~74% from the past levels of March 31, 2017 and stood at ~2.0% of standard advances as on September 30, 2021. Furthermore, gold loans in the SMA 1+2 category stood at Rs. 382 crore or 0.77% of standard advances as on September 30, 2021. The overall stressed assets remained high at 7.7% of advances (~59% of core capital) as on September 30, 2021. The performance of the restructured loan book will remain monitorable, especially in the backdrop of the threat of a third wave of Covid-19. ICRA also notes that KVB has a high share of the BB and below and unrated book, typically due to small/mid-size borrowers. However, the lower level of the SMA 1+2 book provides some comfort on incremental stress.

Lower share of NOI and higher operating expenses remain a drag on profitability – KVB's net interest margins (NIMs) in FY2021 and H1 FY2022 remained below the PVBs' average mainly due to the relatively higher cost of funds and the excess liquidity carried by the bank. KVB's operating expenses have remained above the PVBs' average in the past and remain so on account of high employee expenses. The bank witnessed a substantial rise in employee expenses due to a one-time expense related to a wage settlement provision of Rs. 246 crore in FY2021. This impacted its core operating profitability, which reduced to 1.50% in FY2021 (1.94% in H1 FY2022) from 2.08% in FY2020. However, the decline in the core operating profitability in FY2021 was offset by lower provisioning driven by lower slippages and hefty gains on the bond portfolio amid the declining interest environment. Thus, KVB was able to report a return on assets (RoA) and an RoE of 0.50% and 5.16%, respectively, in FY2021 (0.73% and 7.73%, respectively, in H1 FY2022). The performance of the stressed assets will remain critical for its overall profitability considering the expected moderation in gains on the bond portfolio, going forward.

Moderate scale and geographically concentrated operations – The bank's operations remain geographically concentrated with ~86% of its total branches (781) located in South India and 54% in Tamil Nadu as on September 30, 2021. This resulted in the concentration of advances with 81% of the advances accruing from South India (50% from Tamil Nadu) as on September

30, 2021, accounting for 0.49% of the banking sector advances. As the asset profile is largely granular and retail in nature, the liabilities would be similarly distributed. 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.

Liquidity position: Strong

KVB's liquidity profile remains strong with positive cumulative mismatches in the maturity bucket of up to one year. The liquidity coverage ratio (LCR) was comfortable at 292% in Q2 FY2022 (310% in Q4 FY2021), driven by the excess statutory liquidity ratio (SLR) holding of Rs. 3,879 crore or 5.9% of net demand and time liabilities (NDTL) as on August 13, 2021 coupled with the low level of non-operational deposits and less stable deposits in total deposits.

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 upgrade the rating if KVB continues to improve the granularity of the loan book and the performance of the restructured book, which would remain critical for improving the asset quality, resulting in an improvement in the solvency profile to more than 25% on a sustained basis while maintaining capital cushions of > 2% over the regulatory levels. Also, the bank's ability to improve the profitability, with an RoA of > 1.0% on a sustained basis, would be a rating trigger.

Negative factors – ICRA could revise the outlook or downgrade the ratings if there is a substantial deterioration in the liability franchisee or further weakening in the asset quality or if the solvency position remains weaker than 35% for a prolonged period or the capital cushion declines 2% below the regulatory levels.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA Rating Methodology for Banks
Parent/Group Support	Not Applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the standalone financials of KVB

About the company

Incorporated in 1916 by the local trader community, The Karur Vysya Bank (KVB) is one of the old private sector banks in the country. KVB is a South-based bank and was formed to provide financial support to the traders and agriculturists in and around Karur, Tamil Nadu. As on September 30, 2021, it had a network of 781 branches with South India constituting 87% of the total branches. The bank's net advances stood at Rs. 51,381 crore as of September 30, 2021, 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. In H1 FY2022, KVB reported a net profit of Rs. 274 crore on an asset base of Rs. 75,874 crore compared to a net profit of Rs. 359 crore on an asset base of Rs. 74,623 crore in FY2021.

Key financial indicators (audited)

The Karur Vysya Bank Limited	FY2020	FY2021	H1 FY2021	H1 FY2022
Net interest income	2,348	2,360	1,163	1,318
Profit before tax	272	534	300	374
Profit after tax	235	359	220	274
Net advances	46,098	50,364	47,822	51,381
Total assets	68,278	74,623	71,175	75,874
% CET I/Tier I	15.27%	16.95%	16.35%	16.79%
% CRAR	17.17%	18.98%	18.41%	18.82%
% Net interest margin	3.41%	3.30%	3.34%	3.50%
% PAT / ATA	0.34%	0.50%	0.63%	0.73%
% Return on net worth	3.56%	5.16%	6.57%	7.73%
% Gross NPAs	8.68%	7.85%	7.93%	7.38%
% Net NPAs	3.92%	3.41%	2.99%	2.99%
% Provision coverage excl. technical write-offs	57.06%	58.51%	64.28%	61.28%
% Net NPA / Core capital	28.25%	25.61%	22.31%	23.02%

***Note:** Amount in Rs. crore; All calculations are as per ICRA Research*
***Source:** KVB, ICRA Research*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2022)				Chronology of Rating History for the Past 3 Years					
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating	Date & Rating in FY2021	Date & Rating in FY2020			Date & Rating in FY2019	
					Jan 03, 2022	Mar 30, 2021	Feb 10, 2020	Feb 22, 2019	Jan 11, 2019	Aug 30, 2018	Jun 11, 2018
1	Basel III Tier II Bonds	Long Term	1,200.00	487.00^	[ICRA]A (Positive)	[ICRA]A (hyb) (Stable)	[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)
3	Certificates of Deposit Programme	Short Term	3,000.00	Nil^	[ICRA]A1+	[ICRA] A1+	[ICRA] A1+	[ICRA] A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

^ Data as on January 03, 2022

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 KVB. 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 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: 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
INE036D08015	Basel III Tier II Bonds	Mar-12-2019	11.95%	Jun-12-2029	487.00	[ICRA]A (Positive)
NA#	Basel III Tier II Bonds	NA	NA	NA	713.00	[ICRA]A (Positive)
NA*	Certificates of Deposit Programme	-	-	-	3,000.00	[ICRA]A1+

Source: *KVB; # Yet to be placed; *CD outstanding is NIL as on December 28, 2021*

Annexure-2: List of entities considered for consolidated analysis

Company name	Ownership	Consolidation approach
NA	NA	NA

Source: *KVB*

ANALYST CONTACTS

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

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

Aayush Behal
+91 124 4545 300
aayush.behal@icraindia.com

Hemant Sultania
+91 124 4545 386
hemant.sultania@icraindia.com

RELATIONSHIP CONTACT

Mr. 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

© Copyright, 2022 ICRA Limited. All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA.

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website www.icra.in or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.