

November 17, 2022

City Union Bank Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Issuer Rating [^]	-	-	[ICRA]AA- (Stable); reaffirmed
Certificates of Deposit	25.00	25.00	[ICRA]A1+; reaffirmed
Total	25.00	25.00	

* Instrument details are provided in Annexure I

[^] Issuer rating is an opinion on the general creditworthiness of the rated issuer and is not specific to any particular debt instrument

Rationale

The ratings reaffirmation continues to factor in City Union Bank Limited's (CUB) strong capitalisation profile (core equity tier I (CET I) ratio of 19.02% as on September 30, 2022) along with its healthy profitability and return metrics. Further, the bank's established retail franchise comprises a reasonably granular asset and liability base. However, the relatively low share of current account and savings account (CASA) deposits in the total deposits keeps the cost of interest-bearing funds relatively above the private sector average.

In the near term, the relatively elevated share of stressed loans {overdue loan accounts, i.e. SMA¹⁻² advances, standard restructured advances and net non-performing advances (NNPAs)}, which formed 9.9% of the standard advances as of September 30, 2022, will remain a monitorable. The ability to reduce the same will be key for maintaining the profitability and capital ratios. Besides this, the high regional concentration of CUB's operations as well as the significant share of the top 20 depositors in the total deposits compared to peer banks remain constraining factors from a credit perspective.

The Stable outlook on the rating reflects our expectation that the overall stressed book is likely to ease gradually and incremental credit costs will be absorbed by the bank's operating profits while it maintains a strong capital position and solvency² profile and keeps the same above our negative triggers. Moreover, CUB will continue to maintain a granular asset and liability profile, which will support its liquidity profile.

Key rating drivers and their description

Credit strengths

Strong capitalisation profile supported by healthy internal accruals – CUB's capitalisation profile remains strong with a core equity or CET I and Tier I capital ratios of 19.02% each as on September 30, 2022, which remain comfortably higher than the regulatory requirement of 8.0% and 9.5%, respectively. The capital ratios continue to be supported by healthy internal accruals and the lower risk-weighted density of assets. This is partly driven by the high share of jewel loans (~24% of the gross advances as on September 30, 2022), which attract lower risk weight. Further, internal capital generation has been healthy and adequate to meet the credit growth since the last capital raise concluded in FY2015. We believe that the strong capital position will act as a good cushion against the expected slippages from the stressed book over the near to medium term.

¹ 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

² Solvency is defined as (NNPAs + Net security receipts + Net non-performing investments) / Core capital)

Healthy earnings profile – CUB’s net interest margins (NIMs) expanded to 3.47% in H1 FY2023 from 3.34% in FY2022 (3.55% in FY2021) and was comparable to the private banks’ (PVBs) average (3.6% in FY2022) despite the relatively higher funding cost. NIMs continue to be supported by the granular nature of the loan book to micro, small and medium enterprises (MSMEs), but have come down from past levels mainly on account of the increase in the relatively low-yielding jewel loans. The share of jewel loans continues to rise steadily and accounted for 24% of gross advances as on September 30, 2022, up from 22% as on March 31, 2022. In addition, the improvement in the non-interest income level together with stable operating expenses supported the gains in the core operating profitability to 2.66% of average total assets in H1 FY2023 (2.69% in FY2022, 2.43% in FY2021).

The overall net profitability was also supported by manageable credit costs at 0.82% H1 FY2023 (0.96% in FY2022). As a result, the return on assets (RoA) improved to 1.59% for H1 FY2023 from 1.32% for FY2022 (1.15% in FY2021) and was more or less in line with the PVB average. Lower credit costs are also linked to the relatively lower provision coverage on NPAs although the bank has demonstrated high collectability from its NPAs in the past, leading to lower credit losses. Going forward, a sharper rise in deposit rates, amidst tightening liquidity, as well as the potential impact of inflation and higher servicing costs on vulnerable customers and its impact on near-term profitability will remain monitorable.

Granular asset and liability base – CUB has an established retail franchise with more than 100 years of operations in South India. The top 20 exposures accounted for ~35% of the Tier I capital as on March 31, 2022 (~38% as on March 31, 2021). Similarly, CUB has a strong retail deposits franchise with limited dependence on bulk deposits. Deposits over Rs. 2 crore were less than 10% of the total deposits as on September 30, 2022.

Despite its limited dependence on bulk deposits, the bank’s cost of average interest-bearing funds remained high at 4.39% in H1 FY2023 (4.64% in H1 FY2022; 4.41% in FY2022) compared to the PVBs’ average (3.85% in FY2022). This was on account of the relatively lower share of CASA deposits in the overall deposit base (31.3% as of September 30, 2022; 29.0% as of September 30, 2021).

Credit challenges

Stressed assets remain monitorable – With the impact of the Covid-19 pandemic steadily fading, fresh NPA generation eased to 2.72% of standard advances in H1 FY2023 (3.64% in FY2022). Moreover, recoveries and upgrades continued to step up in H1 FY2023. This, along with lower slippages, helped support a steady improvement in the headline asset quality metrics with gross NPA% and NNPA% at 4.37% and 2.69%, respectively, as on September 30, 2022 against 5.58% and 3.49%, respectively, as on September 30, 2021. However, the overall potential stressed book, comprising the standard restructured book, stood at Rs. 1,965 crore (4.8% of standard advances) as on September 30, 2022, while the SMA-2 accounts stood at ~Rs. 950 crore (2.3% of the standard advances). This remains a monitorable, despite the relative moderation from 9.20% as on September 30, 2021.

Including NNPA, the stressed assets remained high at 9.9% of standard advances (~55% of CET I) as on September 30, 2022 against 9.7% as on March 31, 2022 (~60%). ICRA also notes that the granular and secured nature of advances results in high recovery levels from NPAs and is a potential mitigant against a final loss. The bank had ~Rs. 160 crore of restructuring provisions as on September 30, 2022 (8.1% of restructured book) apart from ~Rs. 105 crore of Covid provisions that can be utilised against incremental stress. ICRA expects that CUB’s healthy operating profitability and strong capital position will help it absorb the asset quality pressure in the coming years while maintaining a strong capital profile.

Geographically concentrated operations – The bank’s operations remain geographically concentrated with ~90% of its total branches (727) located in South India and 68% in Tamil Nadu as on September 30, 2022. As a result, 84% of the advances and 92% of the deposits were from South India (66% and 81%, respectively, from Tamil Nadu) as on September 30, 2022 (86% and 93%, respectively, as on September 30, 2021). Moreover, the share of the top 20 deposits in the bank’s total deposits remained comparatively higher than peer banks at 11.54% as on March 31, 2022 (10.62% as on March 31, 2021). This exposes its assets and liabilities to local socio-economic and political risks. ICRA expects the bank’s operations to remain regionally concentrated with the same unlikely to improve in the medium term.

Environmental and social risks

While banks like CUB 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 whom 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, it could translate into credit risks for banks. However, such risk is not material for CUB 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 lesser downside environmental risks.

With regard to social risks, data security and customer privacy are among the key sources of vulnerability for banks as any material lapses could be detrimental to its reputation and invite regulatory censure. CUB has not faced such lapses over the years, which highlights its sensitivity to such risks. It is seen to be operating responsibly in terms of its selling practices with no instances of fines imposed by the regulatory authorities because of misconduct. Customer preferences are increasingly shifting towards digital banking, which provides an opportunity to reduce the operating costs. CUB has been at the forefront of making the requisite investments to enhance its digital interface with its customers. While it contributes to promoting financial inclusion by lending to the under-served segments, its lending practices remain prudent as reflected in the healthy asset quality numbers in this segment compared with its peers.

Liquidity position: Strong

CUB's liquidity profile remains strong with positive cumulative gaps across all the maturity buckets as per the structural liquidity statement as on June 30, 2022. The bank's excess statutory liquidity ratio (SLR) holding of 3.8% of net demand and time liabilities (NDTL) as on July 29, 2022, coupled with the low level of non-operational deposits and less stable deposits in total deposits resulted in a comfortable liquidity coverage ratio (LCR) of 227% in Q4 FY2022 (271% in Q4 FY2021). Furthermore, the net stable funding ratio (NSFR) stood at 158% in Q4 FY2022 and 162% in Q3 FY2022, which was well above the regulatory ask of 100%.

CUB'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 CUB'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 outside Tamil Nadu, while improving its asset quality and profitability.

Negative factors – ICRA could revise the outlook to Negative or downgrade the ratings if there is a weakening in the solvency profile with the solvency remaining weaker than 25% or if the cushion over the regulatory Tier I capital adequacy falls below 3% on a sustained basis. Further, the inability to internally generate growth capital (RoA below 1.0%) or a deterioration in the liability franchise will be negative triggers.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	ICRA's Rating Methodology for Banks
Parent/Group support	Not Applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the standalone financials of CUB

About the company

Incorporated as The Kumbakonam Bank Limited in 1904, CUB is one of the oldest private sector banks, with its headquarters in Kumbakonam, Tamil Nadu. As on September 30, 2022, it had a network of 727 branches and 1,693 ATMs with about 90% of the

total branches being in South India. About 56% of the branches are in semi-urban and rural areas. CUB reported a capital adequacy ratio of 20.08% (Tier I: 19.02%) and gross and net NPAs of 4.37% and 2.69%, respectively, as of September 30, 2022. In H1 FY2023, the bank reported a net profit of Rs. 502 crore on an asset base of Rs. 64,395 crore compared to a net profit of Rs. 355 crore on an asset base of Rs. 56,435 crore in H1 FY2022.

Key financial indicators (standalone)

City Union Bank	FY2021	FY2022	H1 FY2022	H1 FY2023
Net interest income	1,830	1,916	926	1,093
Profit before tax	693	985	470	647
Profit after tax	593	760	355	502
Net advances (Rs. lakh crore)	0.36	0.40	0.37	0.42
Total assets (Rs. lakh crore)	0.53	0.62	0.56	0.64
CET I	18.45%	19.78%	18.18%*	19.02%*
Tier I	18.45%	19.78%	18.18%*	19.02%*
CRAR	19.52%	20.85%	19.24%*	20.08%*
Net interest margin / ATA	3.55%	3.34%	3.37%^	3.47%^
PAT / ATA	1.15%	1.32%	1.29%^	1.59%^
Return on net worth	10.15%	11.54%	11.80%^	14.75%^
Gross NPAs	5.12%	4.70%	5.58%	4.37%
Net NPAs	2.97%	2.95%	3.49%	2.69%
Provision coverage excl. technical write-offs	43.21%	38.39%	38.92%	39.38%
Net NPA / Core equity capital	19.34%%	18.86%	23.77%*	15.24%*

Source: City Union Bank, ICRA Research; Amount in Rs. crore unless mentioned otherwise; Total assets and net worth exclude revaluation reserves; All ratios as per ICRA's calculations; ^ Annualised; *CET I, Tier I and CRAR exclude profits for H1

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

Instrument	Type	Current rating (FY2023)		Chronology of rating history for the past 3 years			
		Amount rated	Amount outstanding as of Nov 17, 2022	Date & rating in FY2023	Date & rating in FY2022	Date & rating in FY2021	Date & rating in FY2020
		(Rs. crore)	(Rs. crore)	Nov-17-2022	Nov-22-2021	Nov-30-2020	Oct-31-2019
1 Issuer Rating	Long Term	-	-	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)
2 Certificates of Deposit	Short Term	25.00	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

[^] Balance yet to be issued

Complexity level of the rated instruments

Instrument	Complexity Indicator
Issuer Rating	NA
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	Coupon Rate	Maturity	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Issuer Rating	NA	NA	NA	NA	[ICRA]AA- (Stable)
Unplaced	Certificates of Deposit*	NA	NA	7-365 days	25.00	[ICRA]A1+

Source: City Union Bank; * Certificates of deposit outstanding was NIL as on Nov 17, 2022

Annexure II: List of entities considered for limited consolidated analysis

Company Name	CUB Ownership	Consolidation Approach
NA	NA	NA

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Branches



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