

November 09, 2023

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 21.17% as on September 30, 2023) 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 lower 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. Moreover, despite an increase in the overall cost of interest funds, leading to a relative compression in lending margins, the return metrics of the bank continue to remain healthy.

While the bank's headline asset quality metrics remained steady, the share of vulnerable loans {overdue loan accounts, i.e. SMA¹ advances, standard restructured advances and net non-performing advances (NNPAs)}, which formed ~10.4% of the standard advances as of June 30, 2023, continued to be sizeable and it will remain a monitorable from an asset quality standpoint. Nonetheless, the potential vulnerable book went through a sustained moderation from comparatively higher levels in the last 1-2 years. The ability to sustain this reduction will be key for maintaining the profitability and capital ratios. Additionally, 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 ICRA's expectation that the overall vulnerable book is likely to decline further. Moreover, the incremental credit costs will be absorbed by the bank's operating profits while it maintains strong profitability, capital position and solvency² profile, and the bank is expected to maintain the same above negative triggers. Additionally, 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 CET I and Tier I capital ratios of 21.17% each, as on September 30, 2023, which remained 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. Lower risk weights are partly driven by the high share of gold loans (~25% of the gross advances as on September 30, 2023), which attract lower risk weight. Further, internal capital generation has been healthy and

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)

adequate to meet the credit growth since the last capital raise concluded in FY2015. The strong capital position will act as a good cushion against the expected slippages from the stressed book over the near-to-medium term.

Despite compression of lending spreads, earnings profile remains healthy – CUB's net interest margins (NIMs) moderated to 3.17% in H1 FY2024 from 3.38% in FY2023, mainly on the back of increase in deposit rates and the ongoing repricing of the deposit base, resulting in a relative compression of lending spreads. Besides, CUB's net interest margins continue to remain lower than the private banks' (PVBs) average (3.9% in FY2023) on account of the relatively higher funding cost and the increase in the relatively low-yielding gold loans. Despite the moderation, NIMs continue to be supported by the granular nature of the loan book to micro, small and medium enterprises (MSMEs). The share of gold loans continues to rise steadily and accounted for 25% of gross advances as on September 30, 2023, up from 21% as on September 30, 2021. As a result of the comparatively higher operating expenses and compression in NIM, the operating profitability levels moderated to ~2.2% in H1FY2024 (~2.9% in FY2023).

Notwithstanding the moderation in operating profitability, the net profitability was also supported by the decline in credit costs to 0.62% in H1 FY2024 (1.08% in FY2023). As a result, the return on assets (RoA) increased to 1.52% in H1 FY2024 from 1.46% in FY2023 (1.32% in FY2022). 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, incremental increase in the cost of funds, 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 118 years of operations in South India. The top 20 exposures accounted for ~34% of the Tier I capital as on March 31, 2023 (~35% as on March 31, 2022). Similarly, CUB has a strong retail deposit franchise with limited dependence on bulk deposits. More than 75% of the term deposits as on June 30, 2023, have a ticket size of less than Rs. 1 crore.

Despite its limited dependence on bulk deposits, the bank's cost of average interest-bearing funds remained high at 5.28% in H1 FY2024 (4.39% in H1 FY2023; 4.61% in FY2023) compared to the PVBs' average (4.15% in FY2023). This was on account of a relatively lower share of CASA deposits in the overall deposit base (29.6% as of September 30, 2023; 31.3% as of September 30, 2022).

Credit challenges

Asset quality remains a monitorable – The annualised gross fresh NPA generation witnessed a relative moderation to 2.89% in H1 FY2024 from 3.39% in FY2023 and 3.64% in FY2022. Meanwhile, recoveries and upgrades continued to remain strong, resulting in steady headline asset quality metrics with the gross NPA (GNPA) and net NPA (NNPA) at 4.66% and 2.34%, respectively, as on September 30, 2023 (4.36% and 2.69%, respectively, as on September 30, 2022).

Despite the satisfactory asset quality metrics, the overall vulnerable book remained sizeable at ~10.4% of standard advances as on June 30, 2023, even though it witnessed a sustained moderation from higher levels of ~12.8% as on March 31, 2022. Given the relatively higher (though moderating) share of the vulnerable book in relation to the total standard assets and the core capital, its performance will remain monitorable in the near to medium term. Further, the impact of the weakening macro-economic factors could affect the debt-servicing ability of borrowers and the same remains monitorable. Nonetheless, 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 ~89% of its total branches (752) located in southern India and 69% in Tamil Nadu, as on September 30, 2023. As a result, 88% of the advances and 93% of the deposits were from southern India (66% and 81%, respectively, from Tamil Nadu) as on September 30, 2023. Moreover, the share of the top 20 deposits in the bank's total deposits remained comparatively higher than peer banks at 10.94%, as on March 31, 2023 (11.54% as on March 31, 2022). This exposes its assets and liabilities to local socio-economic and political risks. ICRA expects the bank's operations to remain regionally concentrated and it is unlikely to improve in the medium term.

Environmental and social risks

While banks, such as CUB, do not face any material physical climate risks, they are exposed to environmental risks indirectly through their portfolio of assets. If the entities or businesses, to which 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 fewer 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. The bank seems to be operating responsibly in terms of its selling practices, as there are no instances of fines imposed by the regulatory authorities due to 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 excess statutory liquidity ratio (SLR) holding of 7.9% of net demand and time liabilities (NDTL) as on July 28, 2023, which partly supports the positive cumulative gaps across all the near-term maturity buckets as per the structural liquidity statement as on August 31, 2023. Besides, the low level of non-operational deposits and less stable deposits in total deposits resulted in a comfortable liquidity coverage ratio (LCR) of 259% in Q1 FY2024 (230% in Q4 FY2023). Furthermore, the net stable funding ratio (NSFR) stood at 153% in Q1 FY2024 and 166% in Q4 FY2023, which was well above the regulatory ask of 100%. 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 and Financial Institutions |
| 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, 2023, it had a network of 752 branches and 1,662 ATMs with about 89% of the total branches being in South India. About 57% of its branches are in semi-urban and rural areas as on September 30, 2023. CUB reported a capital adequacy ratio of 22.21% (Tier I: 21.17%) and gross and net NPAs of 4.66% and 2.34%, respectively, as of September 30, 2023. In H1 FY2024, the bank reported a net profit of Rs. 508 crore on an asset base of Rs. 67,274 crore compared to a net profit of Rs. 502 crore on an asset base of Rs. 64,395 crore in H1 FY2022.

Key financial indicators (standalone)

| City Union Bank | FY2022 | FY2023 | H1 FY2023 | H1 FY2024 |
|---|--------|--------|-----------|-----------|
| Net interest income | 1,916 | 2,163 | 1,093 | 1,061 |
| Profit before tax | 985 | 1,177 | 647 | 593 |
| Profit after tax | 760 | 937 | 502 | 508 |
| Net advances (Rs. lakh crore) | 0.40 | 0.43 | 0.42 | 0.43 |
| Total assets (Rs. lakh crore) | 0.62 | 0.67 | 0.64 | 0.67 |
| CET I | 19.78% | 21.27% | 19.02%* | 21.17%* |
| Tier I | 19.78% | 21.27% | 19.02%* | 21.17%* |
| CRAR | 20.85% | 22.34% | 20.08%* | 22.21%* |
| Net interest margin / ATA | 3.34% | 3.38% | 3.47%^ | 3.17%^ |
| PAT / ATA | 1.32% | 1.46% | 1.59%^ | 1.52%^ |
| Return on net worth | 11.54% | 12.57% | 14.75%^ | 13.24%^ |
| Gross NPAs | 4.70% | 4.37% | 4.37% | 4.66% |
| Net NPAs | 2.95% | 2.36% | 2.69% | 2.34% |
| Provision coverage excl. technical write-offs | 38.39% | 47.00% | 39.38% | 50.91% |
| Net NPA / Core equity capital | 18.86% | 14.17% | 16.58% | 12.89% |

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 excludes 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 (FY2024) | | Chronology of rating history for the past 3 years | | | |
|---------------------------|------------|-------------------------|---------------------------------------|---|-------------------------|-------------------------|-------------------------|
| | | Amount rated | Amount outstanding as of Nov 09, 2023 | Date & rating in FY2024 | Date & rating in FY2023 | Date & rating in FY2022 | Date & rating in FY2021 |
| | | (Rs. crore) | (Rs. crore) | Nov-09-2023 | Nov-17-2022 | Nov-22-2021 | Nov-30-2020 |
| 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 02, 2023

Annexure II: List of entities considered for limited consolidated analysis

| Company Name | CUB Ownership | Consolidation Approach |
|--------------|---------------|------------------------|
| NA | NA | NA |

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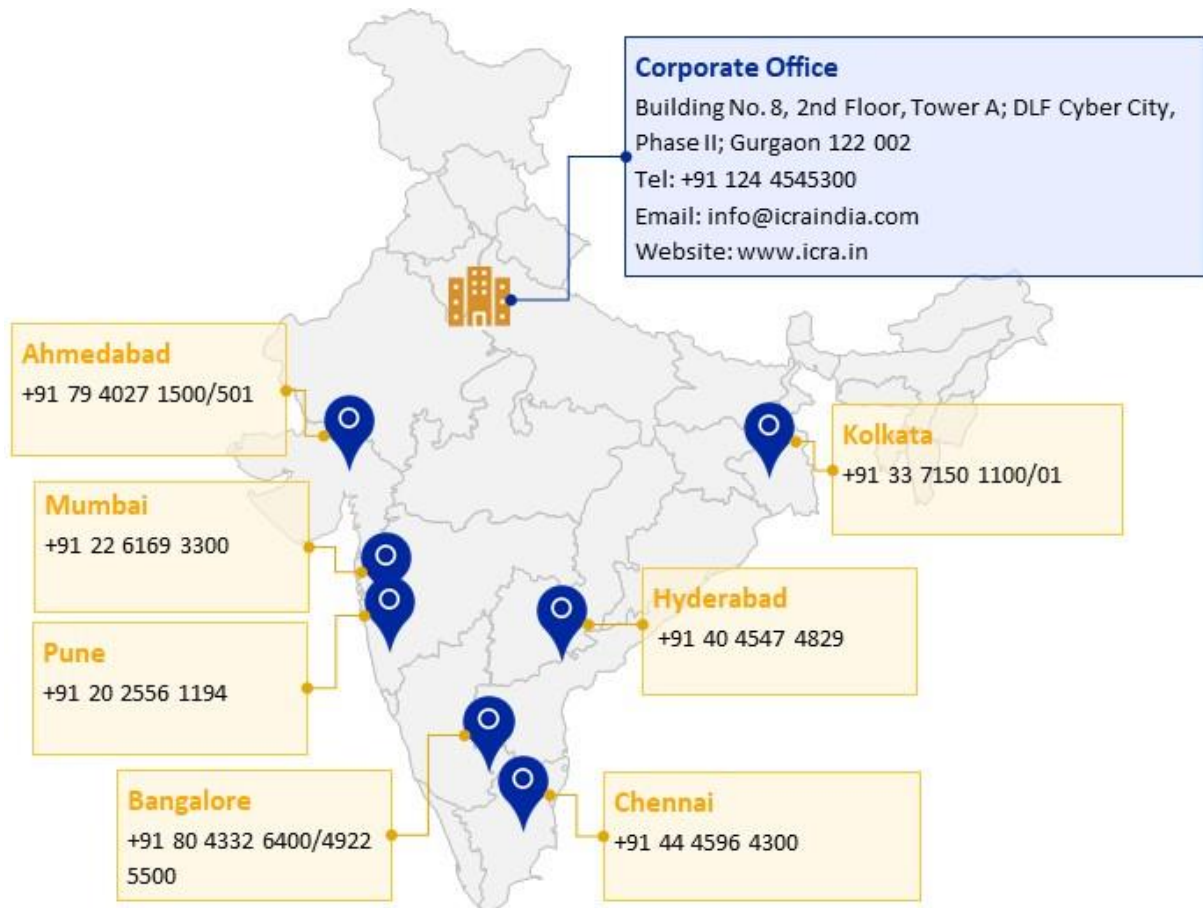
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