February 21, 2023

DCB 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III Tier II bond programme	300	-	[ICRA]A+ (Positive); Reaffirmed, outlook revised to Positive from Stable and rating withdrawn
Basel III Tier II bond programme	13.4	13.4	[ICRA]A+ (Positive); Reaffirmed and outlook revised to Positive from Stable
Short-term fixed deposit programme	-	-	[ICRA]A1+; reaffirmed
Total	**313.4**	**13.4**	

**Instrument details are provided in Annexure I*

Rationale

The revision in the outlook on the long-term rating of DCB Bank Limited (DCB) factors in the improvement in its asset quality with the vulnerable book (special mention account (SMA)-1, SMA-2 and standard restructured book under moratorium) declining gradually. This book, however, remains a near-to-medium-term monitorable as the restructured book is yet to fully exit the moratorium. ICRA also takes note of the well-collateralised loan book and DCB's ability to enforce collateral, leading to lower net slippages. As a result, the headline asset quality metrics continue to improve with low credit costs. Furthermore, the ratings continue to factor in the bank's strong capital cushions while deposit granularisation has continued to progress satisfactorily.

DCB has provided guidance of doubling the book over the next 3-4 years, which may lead to operational leverage over the long term. However, the operating expenses necessary for expanding the franchise are likely to remain high in the near term. Additionally, the bank's ability to match the book growth by mobilising deposits at competitive rates amid rising interest rates and tighter liquidity conditions, thereby narrowing the differential with the private sector average while sustaining granularity, will remain key for building a stable franchise and better cost metrics. The Positive outlook factors in ICRA's expectation that DCB will be able to maintain its headline asset quality and profitability metrics while reducing the vulnerable book and pursuing growth.

ICRA has withdrawn the ratings assigned to the Rs. 300 crore Basel III Tier II Bonds as these bonds are fully redeemed and no amount is outstanding against the rated instruments. The ratings were withdrawn in accordance with ICRA's policy on withdrawal.(click here for the policy).

Key rating drivers and their description

Credit strengths

Capital cushions remain strong – DCB's capital ratios remain strong with the Tier I and the capital-to-risk weighted assets ratio (CRAR) at 14.47% and 16.26%, respectively, as on December 31, 2022, against the regulatory requirement of 9.5% and 11.5%, respectively. DCB's capitalisation profile continues to derive support from its business profile, with focus on small-ticket retail loans (mainly mortgages) that attract lower risk weight. Further, the current operating profitability along with the ability to maintain strong recoveries are likely to drive sufficient internal capital generation for achieving the bank's stated growth targets without relying on raising capital. ICRA expects the capital cushions above the regulatory levels to remain well above the negative rating triggers.

Improving granularity of deposit profile – DCB's overall deposit base grew by 22.6% on a year-on-year (YoY) basis to Rs. 39,506 crores as on December 31, 2022, while net advances grew by 20.56% to Rs. 32,966 crores. Furthermore, the overall granularisation of the deposit base continued to progress satisfactorily during this period with the share of the top 20 depositors at ~7% of total deposits as on December 31, 2022 (6% as on December 31, 2021, and 7% as on March 31, 2022). Additionally, the share of deposits > Rs. 1 crore reduced progressively to ~35% as on September 30, 2022, from ~47% as on March 31, 2019. While the bank was able to maintain the granularity of its deposit base, its ability to maintain the granularity of the deposits at competitive rates, given its growth ambitions, will remain key for building a stable franchise and achieving better cost metrics.

Return metrics improve, though sustainability to be seen – The overall profitability levels witnessed a relative improvement, supported by strong recoveries and upgrades, which helped offset the impact of high slippages in 9M FY2023, thereby leading to lower credit costs. Since the onset of the Covid-19 pandemic, high slippages during FY2021-FY2022 drove up credit costs, which resulted in a moderation in the return metrics. Going forward, rising interest rates and tighter liquidity conditions are expected to pressurise the lending spreads and the net interest margins, which could weigh down the operating profitability level. Hence, the ability to maintain strong asset quality and credit costs will be a key driver of the profitability.

Further, the ongoing expansion of the franchise with investments in infrastructure and employee headcount has increased the operating expenses to 2.75% of average total assets (ATA) from 2.40% in FY2022 and 2.17% in FY2021 and the cost-to-income ratio to 64.5% in 9M FY2023 (60.2% in 9M FY2022). As a result, the ability to derive operational leverage will be critical for sustaining the operating profitability amid rising funding costs.

Credit challenges

Asset quality improves but remains a monitorable – While there has been a relative improvement in the asset quality levels, the overall vulnerable book (SMA-1, SMA-2 and residual standard restructured book under moratorium) remains elevated in relation to the bank's core capital despite easing from the peak level last year. Given the larger share of the self-employed borrower segment, DCB remains relatively more vulnerable to macro-economic shocks. As a result, gross fresh slippages surged in FY2022, with fresh non-performing advances (NPA) generation at 6.99% compared to the range of 2.0-2.8% maintained prior to the onset of the pandemic. The restructuring implemented as a part of Covid relief measures was also among one of the highest in the sector. The annualised fresh NPA generation remained elevated at 6.7% in 9M FY2023 and included a relatively higher share of gold loans, wherein recoveries were high, and loss given default was considerably lower.

Further, DCB's loan book is well collateralised and its ability to enforce the collateral leads to lower net slippages. As a result, the headline asset quality metrics improved in 9M FY2023, with the gross and net NPA% at 3.62% and 1.37%, respectively, as on December 31, 2022 (compared to 4.32% and 1.97%, respectively, as on March 31, 2022). Going forward, the ability to keep slippages at lower levels, ensure high recoveries as demonstrated in the past and reduce the vulnerable book will be key for sustaining the improvement in the asset quality metrics.

Cost of funds remains high in relation to industry average – DCB's overall cost of funds in relation to the private sector average remained higher by 191 basis points (bps) in H1 FY2023 (~208 bps in FY2022 and ~183 bps in FY2021), largely driven by the ongoing efforts to maintain deposit granularity by offering higher interest rates to retail depositors. The share of current and savings accounts (CASA) also improved to 28% of total deposits as on December 31, 2022, partly supported by the higher interest rate offered on these deposits. However, it continues to lag the private sector average of 44-45%, leading to relatively higher costs compared to peer banks operating with a higher CASA share.

Environmental and social risks

Given the service-oriented business of the bank, its direct exposure to environmental risks as well as those emanating from regulations or policy changes is not material. While the bank is not directly engaged in activities which could have a serious impact on the environment, but secondary emissions would be largely on account of the exposure of the bank towards less environment friendly sectors. However, with a high share of the retail book of the bank, the share of the corporate book exposures is low, which is likely to have been more environmentally friendly.

Social considerations – The Bank is guided by Reserve Bank of India (RBI) prescribed guidelines on priority sector lending, lending to small and marginal farmers, lending to weaker section etc., and government-led initiatives to improve access to financial services, to disadvantaged, vulnerable and marginalized stakeholders. The Bank renders services to the disadvantaged, rural/semiurban section of the society by providing basic banking services at their doorstep. The Bank has reached the deprived segment of the society and extended its focused financial services through banking Correspondents. The Bank has undertaken several CSR initiatives with positive direct environmental impact or towards creating awareness among stakeholders, in areas of skill development & sustainable livelihoods, education, primary healthcare & sanitation etc.

Liquidity position: Adequate

DCB's daily average liquidity coverage ratio (LCR) stood at 128.6% for Q3 FY2023 (139.33% for Q2 FY2023 and 143.92% for Q1 FY2023) against the regulatory requirement of 100%, while the net stable funding ratio (NSFR) stood at 122.36%, well above the regulatory level of 100%. Additionally, the excess statutory liquidity ratio (SLR) stood at 7-8% of the net demand and time liabilities (NDTL). The excess SLR can be utilised to avail liquidity support from the Reserve Bank of India (RBI).

Rating sensitivities

Positive factors – ICRA could upgrade the rating if the bank achieves a sustained improvement in the asset quality and profitability while keeping the capital cushions above the regulatory levels.

Negative factors – ICRA could change the outlook to Stable on a deterioration in the asset quality or capital position, leading to the weakening of the solvency profile with net NPA/core equity of >25% on a sustained basis. Further, a sustained return on assets (RoA) of <0.7% and/or a decline in the capital cushions to <2% in relation to the regulatory requirement (including capital conservation buffers) on a sustained basis will remain negative triggers. Moreover, a material weakening in the liability franchise, impacting its resource profile, will be a negative trigger.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	ICRA's Rating Methodology for Banks and Financial institutions ICRA's Policy on Withdrawal of Credit Ratings
Parent/Group support	Not applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the standalone financials of DCB Bank

About the company

Incorporated in 1995, DCB Bank was formed through the merger of Ismailia Co-operative Bank Limited and Masalawala Cooperative Bank. The Aga Khan Fund for Economic Development (AKFED) and Group companies are the largest shareholders in the bank with a combined stake of 14.85% as on December 31, 2022. DCB Bank had a network of 418 branches and 385 ATMs as on December 31, 2022.

Key financial indicators (audited) – Standalone

DCB Bank Limited		FY2021	FY2022	9M FY2022^	9M FY2023^
Net interest income	Rs. crore	1,287	1,358	977	1,231
Profit before tax	Rs. crore	453	390	236	436
Profit after tax	Rs. crore	336	288	174	323
Net advances	Rs. crore	25,737	29,096	27,343	32,966
Total assets	Rs. crore	39,602	44,840	41,178	49,866
CET	%	15.49%	15.84%	15.10%*	14.47%*
Tier I	%	15.49%	15.84%	15.10%*	14.47%*
CRAR	%	19.67%	18.92%	18.21%*	16.26%*
Net interest margin / Average total assets	%	3.29%	3.22%	3.23%	3.47%
Net profit / Average total assets	%	0.86%	0.68%	0.57%	0.91%
Return on net worth	%	8.93%	7.10%	6.03%	10.18%
Gross NPAs	%	4.09%	4.32%	4.73%	3.62%
Net NPAs	%	2.29%	1.97%	2.52%	1.37%
Provision coverage excl. technical write-offs	%	45.16%	55.56%	48.01%	62.95%
Net NPA/ Core capital	%	16.55%	14.89%	19.39%	11.66%

*Source: DCB Bank, ICRA Research; All ratios as per ICRA's calculations; *Excluding 9M profits; ^ Unaudited numbers*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

S No	Name of Instrument	Current Rating (FY2023)				Chronology of Rating History for the Past 3 Years		
		Type	Rated Amount (Rs. crore)	Amount Outstanding (Rs. crore)	Feb 21, 2023	Date & Rating in FY2022	Date & Rating FY2021	Date & Rating FY2020
						Feb 21, 2022	Feb 26, 2021	Jan 31, 2020
1	Short-term fixed deposits	Short term	-	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
2	Basel III Tier II bonds programme	Long term	300.0	-	[ICRA]A+ (Positive); Withdrawn	[ICRA]A+ (Stable)	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)
2	Basel III Tier II bonds programme	Long term	13.4	-^	[ICRA]A+ (Positive)	[ICRA]A+ (Stable)	[ICRA]A+(hyb) (Stable)	[ICRA]A+(hyb) (Stable)

^ Balance yet to be placed

Complexity level of the rated instrument

Instrument	Complexity Indicator
Basel III Tier II bond programme	Highly Complex
Short-term fixed deposit programme	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 / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE503A08036	**Basel III Tier II bonds**	Nov 17,2017	9.85%	Nov 17, 2027^	300.00	[ICRA]A+ (Positive); withdrawn
Unplaced	**Basel III Tier II bonds**	NA	NA	NA	13.40	[ICRA]A+ (Positive)
NA	**Short-term fixed deposits**	NA	NA	NA	NA	[ICRA]A1+

Source: DCB Bank; ^ Redeemed by exercising call option

Key features of rated debt instruments

The servicing of the Basel III Tier II bonds is expected to absorb losses once the point of non-viability (PONV) trigger is invoked by the RBI. The Basel III Tier II bonds have equity-like loss-absorption features. Such features may translate into higher loss severity vis-à-vis conventional debt instruments.

Annexure II: 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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