India Ratings Upgrades The Federal Bank's Basel III Tier 2 Bonds to 'IND AA+'; Outlook Stable

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India Ratings and Research (Ind-Ra) has upgraded the rating of The Federal Bank Limited's (FBL) Basel III Tier 2 bonds to 'IND AA+' from 'IND AA'. The Outlook is Stable. The detailed rating action is as follows:

Instrument Type	Date of Issuance	Coupon Rate (%)	Maturity Date	Size of Issue (billion)	Rating/Outlook	Rating Action
Basel III Tier 2 debt*	-	-	-	INR20	IND AA+/Stable	Upgraded

*Details in Annexure

Analytical Approach: Ind-Ra has taken a standalone view of FBL for the rating review.

The upgrade reflects the consistent strengthening of FBL's credit profile as reflected in scaling up of franchise, stable liability franchise, improving diversification of its loan portfolio outside the home state (Kerala), a reasonably well-managed asset quality and improved profitability buffers.

Key Rating Drivers

Sizeable Franchise with Reducing Concentration in Home State: FBL continues to have a large presence in the southern states of the country with a huge asset and liability franchise. The bank is diversifying away from Kerala, where its share in the overall advances moderated to 31.6% in 1HFY24 (FY15: 42.6%), while the share of Tamil Naidu and Karnataka rose to 13.8% (11.2%) and 9.0% (6.5%), respectively. As of 2QFY24, the bank's loan portfolio was INR1,928 billion (of which 54.3% originated in Kerala, Tamil Nadu and Karnataka) and it had a deposit base of INR2,328 billion (57.6% in Kerala). Also, the bank's incremental efforts are on increasing share in Maharashtra, whose advance share has increased to 22.6% in 1HFY24 (FY15: 19.7%) and deposits share to 14.0% (8.1%).

Furthermore, the bank has a well-diversified advances portfolio across segments, comprising corporates (3QFY24: 34.8%; FY23: 36.3%; FY22: 36.3%), retail (31.4%; 31.6%; 30.4%), small and medium-sized enterprises (SMEs; 18.1%; 17.7%; 19.0%) and agriculture (12.9%; 13.2%; 13.4%%). The retail loan book grew 24.0% yoy in 3QFY24, against the overall gross loan growth of 21.0% yoy. The gold loan book grew 22.5% yoy to INR239.2 billion as of 3QFY24, accounting for 11.6% of the overall gross loan book.

Stable and Well-Diversified Granular Funding Profile: FBL has a well-diversified granular deposit profile with a low reliance on bulk deposits. Its granular deposits (deposits lower than INR20 million) constituted 81% of the total deposits as of 3QFY24 with the overall current accounts and savings accounts constituting 30.6% of the total deposits. Kerala is a home town for non-resident Indians (NRIs) where all accounts reside. The origination of deposits takes place outside India and across various states in India, thereby moderating the geographical concentration risk. Non-resident external deposits stood at 30.3% of the total deposits in 3QFY24 (FY23: 33.1%; FY22: 37.1%) and have been largely stable over the years. Further, the bank has maintained its NRI deposits share/total deposits and its share in NRI remittances was 19.3% as of 3QFY24 (FY23: 19.3%, FY22: 21.06%, FY21: 18.20%). This large granular funding is helping FBL to maintain lower funding costs than that of its large peers. The bank has shown stability in maintaining and gaining the share of NRI remittances in Kerala. However, rising competition and impact of inflation across capital flows could slowdown accretion of NRI deposits, which remains a rating monitorable.

The bank is using its relationships on the wholesale side to bring in corporate salary customers and open current account deposits. The bank has a tie-up with Jupiter and Epifi on the liability side and it plans to tap the customer base of these fintechs for credit cards and PL products. The product per customer is still below two, which has the potential to further increase.

Strengthened Management Team: The bank has had a substantial number of lateral hires across key verticals, who bring in significant amount of experience and knowledge with them, thus enhancing management capabilities. This also reduces the risk of possible disruptions in the event of any senior-level exits; although, the tenor of the managing director has been approved until September 2024, however, the board has already started the search process using the top quality search firms and after choosing among internal/external candidates it will seek Reserve Bank of India’s approval. Further, the bank has established a second-layer team under each business vertical head to adapt to any transition at the senior level.

As part of its strategy, the management continues to focus on the retailisation of the loan book with controlled risk underwriting, adoption of digitisation to improve branch-level productivity and increasing the wallet share with customers. The management has stated that the unsecured lending would be capped at 10% of the overall assets under management, which could be achieved over the course of the next two financial years. Under large corporates, the bank aims to lend to higher-rated entities while focusing on driving growth through mid-corporate segment in the medium-to-long term.

Liquidity Indicator - Adequate: FBL’s asset-liability profile was matched as of 9MFY24. It had a high liquidity coverage ratio of 119.92% and a net stable funding ratio of 129.93% as of 3QFY24. The liability is largely retail-oriented and granular; the ratio of the top 20 deposits to the overall deposit was modest at 6.9% in 2QFY24 (FY23: 5.19%; FY22: 3.35%).

Stable and Adequately Provided Asset Quality: The bank’s gross non-performing assets moderated to 2.29% in 3QFY24 (FY23: 2.36%; FY22: 2.8%), with improved recoveries and upgradation. FBL’s provision coverage ratio improved to 72.3% in 3QFY24 (71.2%; 66.3%). However, the absence of any large, stressed exposure will contain the impact on credit cost and normalise the same in the medium term. The concentration risk, in terms of the top 20 group exposures to the total advances, remained at 8.11% in FY23 (FY22: 9.44%)

FBL’s total stressed book (net non-performing assets + standard restructured assets + net security receipts) stood at 1.75% of the loan book at 3QFYE24 (FYE23: 2.31%; FYE22: 3.4%), and net stressed asset/net worth stood at 12.4% (18.8%; 26.8%). Ind-Ra expects the impaired book to stabilise in the medium term, along with incremental loan growth in better-rated borrowers and increased focus on retail growth.

Incremental Improvement in Profitability to be Driven by Focus on Growing High Yielding Book: FBL’s net interest margin declined 36bp yoy to 3.19% in 3QFY24 (FY23: 3.31%, FY22: 3.20%), largely because of higher flows towards term deposits and lower CASA ratio. However, the overall deposits profile was supported by its strong low-cost retail liability franchise, a shift in loan mix towards high-yielding retail loans and the increase in gold loan proportion in the overall book. FBL’s profitability remains adequate on risk-adjusted basis; where profit after tax to risk weighted assets stood at 2.26% for 9MFY24 (FY23: 2.13%; FY22: 1.68%), largely due to the lower credit cost and improved loan book growth, which stands comparable with peers’.

Further, while the bank expects the retail/wholesale share to remain intact at 55:45, the share of higher yielding book (excluding gold loans), which includes credit cards, personal loans, MSME (business loan + commercial banking; 18.2%), commercial vehicle/commercial equipment and microfinance is improving and stood at about 24.6% in 3QFY24 (3QFY23: 21.4%). The share of these segments in the bank's interest income increased to 26.9% from 23.9% during the same period.

The bank's pre-provision operating profit buffer (9MFY24: 1.97% of average assets; FY23: 1.99%; FY22: 1.79%) has largely remained stable. However, the pre-provision operating profit buffer stands lower than that of higher rated banks. The bank's pensionable employees share in the total employees has been moderating. Management expects the share of pensionable employees would further moderate in the medium term with increased seasoning, thereby moderating the volatility in employee cost with movements in interest rates. The bank has guided to maintain a cost/income ratio of around 50% in the medium term.

Adequate Capital Buffers: FBL's capitalisation (3QFY24 Tier 1 ratio: 13.5% excluding 9MFY24 profits, 3QFY22: 12.1%) has increased due to higher internal accruals and capital raise of INR9.59 billion in July 2023 from International Finance Corporation and INR30.40 billion from a qualified institutional placement. The bank also has a material stake in its subsidiaries, which can be liquidated in the event of stress. According to Ind-Ra's stress test, FBL is likely to maintain a common equity tier-1 (CET1) ratio above the regulatory minimum and system average, and the management has guided it will maintain the floor threshold of CET1 ratio at 12%.

Rating Sensitivities

Positive: FBL's improved visibility on the diversification of asset profile outside its core geographies, sustained market share gains on both asset and liabilities, traction in the new retail products with adequate seasoning , build-up of other non-interest revenue streams, along with a sustained diversification in operating geographies comparable to peers will lead to a positive rating action.

Negative: Events that could, individually or collectively, lead to a negative rating action are:
- deterioration in the funding profile due a fall in low-cost deposits, a rise in operating expenses, a prolonged decline in the profitability buffers driven by asset quality pressures and any deviation from the aforementioned positive rating sensitivities above Ind-Ra's expectations,
- any material impact on Tier I capitalisation levels with CET I capital falling below 12% on a sustained basis,
- a significant increase in net NPA or a decline in CET1,
- a significant erosion of the franchise (sustained reduction of market share in advances or deposits),
- a weakening of the bank's competitiveness in the industry.

ESG Issues

ESG Factors Minimally Relevant to Rating: Unless otherwise disclosed in this section, the ESG issues are credit neutral or have only a minimal credit impact on FBL, due to either their nature or the way in which they are being managed by the entity. For more information on Ind-Ra's ESG Relevance Disclosures, please click here. For answers to frequently asked questions regarding ESG Relevance Disclosures and their impact on ratings, please click here.

Company Profile

FBL was established in 1931 in Aluva (Kerala), and is classified as an old private sector bank by the Reserve Bank of India. FBL is the second-largest bank and the largest private sector bank in Kerala, with nearly 42% of its 1,418 branches located in the state. The bank has a strong retail funding franchise, including a stable base of NRI deposits, largely contributed by remittances from the expatriate Indian community in the Middle East.

FINANCIAL SUMMARY

Particulars	9MFY24	FY23	FY22
Total assets (INR billion)	2,962.1	2,603.4	2,209.5
Total net worth (INR billion)	280.8	214.2	186.6
Net profit (INR billion)	28.1	30.1	18.9
Return on assets (%)	1.35	1.28	0.94
Tier 1 ratio (%)	13.5*	13.0	14.4
Capital adequacy ratio (%)	15.0	14.8	15.8
Gross non-performing asset ratio (%)	2.29	2.36	2.8
Impaired asset (net non-performing assets + standard restructured assets + net SR) as percentage of advances (%)	1.75	2.31	3.45
Source: FBL, Ind-Ra *excluding 9M profits			

Non-Cooperation with previous rating agency

Not applicable

Solicitation Disclosures

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APPLICABLE CRITERIA

Rating Bank Subordinated and Hybrid Securities

Rating of Financial Institutions Legacy Hybrids and Sub-Debt

Evaluating Corporate Governance

The Rating Process

Financial Institutions Rating Criteria

Rating History

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook			
	Rating Type	Rated Limits (billion)	Rating	27 February 2023	8 July 2022	14 September 2021	1 March 2021
Basel III Tier 2 debt	Long-term	INR20	IND AA+/Stable	IND AA/Positive	IND AA/Positive	IND AA/Stable	IND AA/Stable

Annexure

Instrument	ISIN	Date of Issuance	Coupon Rate (%)	Maturity Date	Size of Issue (billion)	Rating/Outlook
Basel III Tier 2 debt	INE171A08024	20 June 2019	9.75	20 June 2029	INR3	IND AA+/Stable
Basel III Tier 2 debt	INE171A08032	20 January 2022	8.20	20 January 2032	INR7	IND AA+/Stable
Basel III Tier 2 debt	INE171A08040	29 March 2023	8.84	29 March 2033	INR9.95	IND AA+/Stable
				Total utilised **Total unutilised**	**INR19.95** **INR0.05**	

Complexity Level of Instruments

Instrument Description	Complexity Indicator
Basel III Tier 2 debt	Moderate

For details on the complexity level of the instrument, please visit https://www.indiaratings.co.in/complexity-indicators.

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