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India Ratings Downgrades Jammu & Kashmir Bank to ‘IND AA-’; Places on RWN

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India Ratings and Research (Ind-Ra) has downgraded Jammu & Kashmir Bank Ltd’s (JK Bank) Long-Term Issuer Rating to ‘IND AA-’ from ‘IND AA’ while placing it on Rating Watch Negative (RWN). The Outlook on the earlier rating was Negative. The instrument-wise rating actions are as follows:

Instrument Type	Date of Issuance	Coupon Rate	Maturity Date	Size of Issue (billion)	Rating/Rating Watch	Rating Action
Basel III compliant Tier II bonds*	-	-	-	INR20	IND AA-/RWN	Downgraded; Placed on RWN
Lower Tier II bonds*	-	-	-	INR6	IND AA-/RWN	Downgraded; Placed on RWN

*Details in annexure

Analytical Approach: Ind-Ra has considered JK Bank’s subsidiary JKB Financial Services Ltd. in its analysis.

Ind-Ra has placed the ratings on RWN following the government’s announcement of revoking Article 370 and Article 35A and bifurcating Jammu and Kashmir (J&K) into two union territories – Jammu & Kashmir and Ladakh. Article 370 of the India Constitution gives a special status to J&K, while Article 35A provides special rights and privileges to the citizens of the state. As of 5 August 2019, the article has been declared as abrogated by the government of India (GoI), pending the signed approval of the President of India.

J&K Bank was majority owned by the state government of J&K (59.2%) and plays a significant role in the economy of J&K state. Ind-Ra will resolve the RWN once it attains further clarity on the impact of the said announcement on the profile of JK Bank.

The downgrade reflect Ind-Ra’s expectations of JK Bank to continue to face capitalisation pressure (especially common equity tier 1; CET1) in view of its growth aspirations and pressure on asset quality and credit costs, along with the need for provisioning catch-up on certain accounts when compared to other banks. While the bank expects to receive an equity infusion from the government of J&K, there is limited clarity on the timing and quantum.

The agency continues to factor in the systemic support that the bank is expected to receive from the state government in case of distress, given the bank’s systemic importance in the state and its established market position in the state. Ind-Ra also expects that the GoI will continue to provide budgetary and other forms of support to the state. The ratings also factor the bank's healthy resource profile in the state.

KEY RATING DRIVERS

State Support Key to Maintain Adequate Capital Buffers: JK Bank’s CET1 ratio was 9.13% in FY19 (FY18: 9.24%). In Ind-Ra’s assessment, the equity capital level is lower than of the levels observed for peers (public and private sector banks) with an ability to grow by about 15 % annually. In addition, the bank’s internal accruals are likely to remain modest, as the credit cost pressure remains.

In view of provision catch-up in FY20 to the levels of peers' and incremental provision requirement on ageing of non-performing loans, Ind-Ra expects the bank to witness credit costs of INR20 billion-25 billion over FY20-FY21; this would keep accruals and thereby capital under pressure. In addition, Ind-Ra expects the bank to require a minimum INR6 billion-7 billion of equity to maintain adequate capital buffers (over the minimum CET requirements), as its ability to tap capital markets is limited. Ind-Ra expects INR1.75 billion-2.00 billion of capital release and similar quantum of provision release as about INR35 billion of loans restructured on account of political disturbances could be reclassified as standard. The J&K government has infused equity in the bank in the past, when required. Therefore, Ind-Ra expects similar support, as and when required.

Modest Asset Quality: JK Bank loan portfolio grew about 16.4% yoy to INR662,500 million in FY19, leading to unseasoned portfolio, particularly in J&K (22.85%). The bank's gross non-performing asset (GNPA) ratio remained almost stable at about 8.97% in FY19 (FY18: 10%, FY17: 11.2%), primarily on account of a sharp increase in advances (FY19: INR692.53 billion, FY18: INR601.28 billion, FY17: INR533.91 billion) and write offs. The slippages (FY19 slippages to gross advances outstanding as on previous fiscal: 4.9%, FY18: 5.8%, FY17: 7%) were primarily driven by the bank's corporate exposure outside J&K and special regulatory debt restructuring on account of socio-political disturbances in the state in FY17.

Ind-Ra expects slippages to decline during FY20 as compared to the previous fiscals; however, GNPAs are likely to remain at elevated levels in the near term due to continued stress in the corporate advances segment. The agency expects slippages in FY20 to mainly result from standard stressed, restructured assets (restructured standard, S4A, strategic debt restructuring, etc. (mainly corporate assets) and SMA 1 and SMA 2 exposures.

Systemic Importance: The ratings reflect Ind-Ra's expectation of continued financial support from the J&K government (FY17-FY18: INR5.3 billion of equity infusion). Ind-Ra opines JK Bank carries higher systemic importance relative to its size considering it is a dominant bank in the strategically important (65% share in the banks' advances in the state and 65% in deposits) and socio-politically sensitive state of J&K where the resources spent by the GoI are disproportionate to the size and population of the state. It plays a major role in the state economy and acts as one of the two agent banks of the Reserve Bank of India in J&K. At end-March 2019, the bank had nearly 812 branches of the overall 2,073 branches of scheduled commercial banks in the state.

Moderate Profitability: JK Bank has a wide net interest margin of 3.5%-4.0% since FY14. The margin is likely to be maintained in view of low-cost deposits which form over 49% of the total funding profile and the bank's ability to command higher yields on the J&K portfolio. Growth in the advances portfolio, especially in J&K, has the capability to expand the pre-provisioning operating profit and provide higher ability to tolerate credit costs. Nevertheless, it increases the state level concentration risk the bank could face. However, credit costs are likely to be the most important driver of profitability in FY20 and FY21. Ind-Ra expects the bank's credit costs to remain high in FY20 and FY21 mainly on account of aging related provisioning requirements on the current stock of stressed corporates and provision catch-up.

Comfortable Liquidity: JK Bank had marginal short-term funding gap of 2.0% of total assets on asset-liability management in up to one-year maturity bucket at FYE19. In comparison, this varies from marginal surplus to a deficit of 25%-30% for most scheduled commercial banks. The bank maintained about 24% of the total assets in balances with the RBI (part of the asset-liability management) and in government securities in FY19, which gives Ind-Ra the comfort that JK Bank is adequately placed to meet its short-term funding requirements. Moreover, JK Bank maintained liquidity coverage ratio of 335.4% at FYE19, against the regulatory requirement of 100%.

Corporate Governance under Scrutiny: On 8 June 2019, the bank announced the cessation of Mr. Parvez Ahmad Nengroo as the chairman and managing director of the bank and as a director on the board with immediate effect. This move is in line with the investigation ordered by the J&K government, following allegations of malpractices in the corporate governance and recruitment processes of the bank. The Anti-Corruption Bureau is investigating the matter and has conducted an inspection of the head office. Mr. R K Chibber, who was earlier designated as an executive president, has been appointed as the bank's interim chairman and managing director for three months. Ind-Ra currently takes on board the bank's submission that the allegations, if proved to be true, would not impact the financial metrics of the bank.

The agency will take appropriate rating action based on its assessment of the potential impact of these and additional developments on the credit profile of the bank and/or the outcome of the investigations.

RATING SENSITIVITIES

Positive: Events that could individually or collectively lead to a positive rating action are:

- Significantly higher capital buffers than regulatory levels, adequate to meet the growth ambitions of the bank and withstand capital erosion in case of high credit costs and withstand moderate concentration risks.
- Moderate capital infusion as envisaged by the agency and non-significant findings in the ongoing investigations could lead to the revision of Outlook to Stable.

Negative: Events that could individually or collectively lead to a negative rating action are:

- Failure to substantiate the quantum and the timeliness of capital infusions from the state government in line with the agency's view of the special status of JK Bank, which needs to be demonstrated by the maintenance of strong capitalisation to manage growth and cover credit costs, as well as reasonably high buffers above the regulatory levels.
- Any significant findings by the investigating agencies in the ongoing investigations that may result in material impact on the bank's financials or raise larger questions on the propriety of the bank's processes.

- Any significant impact of revocation of Article 370 and Article 35A affecting the systemic importance and credit profile of the bank.

COMPANY PROFILE

Srinagar-based JK Bank was established in 1938 by the state government. It is majority-owned (59.23% as of March 2019) by the J&K government. The bank has 938 branches and 1,291 ATMs as of 31 March 2019.

FINANCIAL SUMMARY

Particulars	**FY19**	**FY18**
Total assets (INR billion)	1014.06	896.87
Total equity (INR billion)	66.26	61.61
Net income (INR billion)	4.65	2.03
Return on average assets (%)	0.49	0.24
Equity/assets (%)	6.53	6.87
Capital adequacy ratio (%)	12.46	11.42
Source: Company, Ind-Ra		

RATING HISTORY

Instrument Type	**Current Rating/Rating Watch**			**Historical Rating/Outlook**		
	Rating Type	**Rated Limits (billion)**	**Rating**	**30 November 2018**	**15 December 2017**	**5 May 2016**
Issuer rating	Long-term	-	IND AA-/RWN	IND AA/Negative	IND AA/Stable	IND AA/Stable
Basel III Compliant Tier 2 bonds	Long-term	INR20	IND AA-/RWN	IND AA/Negative	IND AA/Stable	IND AA/Stable
Lower Tier 2 bonds	Long-term	INR6	IND AA-/RWN	IND AA/Negative	IND AA/Stable	IND AA/Stable

ANNEXURE

ISIN	**Instrument**	**Date of Issue**	**Coupon Rate (%)**	**Maturity Date**	**Size of Issue (billion)**	**Rating/Rating Watch**
INE168A08038	Basel III compliant Tier 2 bonds	24 March 2017	9.50	24 June 2022	INR5	IND AA-/RWN
INE168A08046	Basel III compliant Tier 2 bonds	28 December 2017	9.25	27 December 2024	INR5	IND AA-/RWN
	Total unutilised				**INR10**	
	Total				**INR20**	

ISIN	**Instrument**	**Date of Issue**	**Coupon Rate (%)**	**Maturity Date**	**Size of Issue (billion)**	**Rating/Rating Watch**
INE168A08012	Lower Tier 2 bonds	30 December 2009	9.00	30 December 2019	INR6	IND AA-/RWN
	Total				**INR6**	

COMPLEXITY LEVEL OF INSTRUMENTS

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

SOLICITATION DISCLOSURES

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Applicable Criteria

Financial Institutions Rating Criteria
Rating Bank Subordinated and Hybrid Securities

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