

March 25, 2022

Karnataka Bank Limited: [ICRA]A (Stable) assigned to Basel III Tier II Bonds; Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel II Lower Tier II Bonds	250.00	250.00	[ICRA]A (Stable); reaffirmed
Basel III Tier II Bonds	720.00	720.00	[ICRA]A (Stable); reaffirmed
Basel III Tier II Bonds	-	300.00	[ICRA]A (Stable); assigned
Certificates of Deposit	1,500.00	1,500.00	[ICRA]A1+; reaffirmed
Total	2,470.00	2,770.00	

*Instrument details are provided in Annexure-1

Rationale

The ratings continue to factor in Karnataka Bank Limited's (KBL) established retail deposit franchise in southern India, which imparts stability and granularity to its deposit profile with the share of the top 20 deposits in total deposits remaining the lowest among peers. Further, KBL has a strong liquidity profile with positive cumulative mismatches across all the maturity buckets in the less-than-one-year category and a high liquidity coverage ratio (LCR) of ~288% in Q3 FY2022. The ratings are also supported by the bank's adequate capitalisation with Tier I of 11.74% as on December 31, 2021.

The ratings remain constrained by the increasing asset quality pressure indicated by the high overall stressed loan book {overdue loan accounts, i.e. SMA¹ 1 and 2 books, standard restructured advances and net non-performing advances (NNPAs)} in relation to the core capital compared with peer banks. The bank's ability to reduce its stressed loan book will be critical for an improvement in its solvency² profile. The ratings are also constrained by the high regional concentration of KBL's operations as well as the high share of the top exposures in relation to the core capital compared to peer banks.

Given the high level of net stressed assets, the credit provisions are expected to remain high in the near term and the internal capital generation is unlikely to improve in the next couple of years. The equity valuation has constrained KBL's capital raising in the past, but it has proposed a capital raise over the next few quarters in tranches. ICRA expects the same to be critical for an improvement in KBL's loss-absorption cushions and solvency levels.

The Stable outlook on the long-term rating reflects ICRA's expectations that the bank will continue to maintain its strong deposit profile and reduce its level of stressed assets while improving the loss-absorption cushion through a capital raise in the near term. Inability to do so could result in a change in the outlook or a ratings downgrade.

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

Key rating drivers and their description

Credit strengths

Established regional franchise in Karnataka – KBL has an established presence of over 97 years in southern India. Its long-standing regional franchise in Karnataka provides access to core retail deposits. The share of retail term deposits in total term deposits remained high at 99.9% as on December 31, 2021. As a result, KBL's dependence on bulk deposits remains limited.

Despite a reduction during the last few years, the bank's cost of average interest-bearing funds remained high at 4.70% in 9M FY2022 (5.28% in FY2021) compared to the private banks' (PVBs) average of 3.93% in 9M FY2022 (4.47% in FY2021) on account of the relatively lower share of current account savings account (CASA) deposits in the overall deposit base. However, KBL's CASA ratio increased to 31.30% as on December 31, 2021 from 30.07% as on December 31, 2020 and is comparable with similarly-sized peers. Also, in terms of granularity of deposits, the share of the top 20 deposits in the bank's total deposits remained the lowest among peers at 3.45% as on December 31, 2021.

Adequate capitalisation levels; however, capital required in the near term to improve cushion against possible asset quality stress – KBL's capitalisation profile remains adequate but at the lower end of its peer banks with a CET I/Tier I capital ratio of 11.74%³ as on December 31, 2021 (11.35% as on December 31, 2020) compared to the regulatory requirement of 9.5%. The bank has proposed a capital raise in tranches by issuing up to 15-crore equity shares, which could result in a capital raise of Rs. 850-870 crore (48-49% of market capitalisation) at the current market valuation if fully issued. This should be sufficient to achieve a growth of 6-7% over the next couple of years while maintaining the Tier I capital cushion above the negative triggers and also improve its solvency profile. Given the equity valuation multiples and the large capital raise being proposed, the mode of capital raising remains a monitorable.

Credit challenges

Significant increase in stressed assets – Despite the stress induced by the Covid-19 pandemic on the cash flows of the borrowers, KBL's fresh gross slippages declined compared to FY2020. The headline asset quality numbers, as reflected in the gross NPAs (GNPAs) and NNPAAs, also showed an improvement. The reduction in slippages was supported by various regulatory measures such as moratorium on debt servicing and standstill on asset classification in FY2021. Further, one-time restructuring of loans resulted in an improvement in the headline asset quality numbers. Notwithstanding the above, KBL's stressed assets, i.e. SMA-1 and SMA-2 accounts, stood high at 4.88% of the standard advances as on December 31, 2021, down from 7.14% as on March 31, 2021 on account of the high restructuring undertaken by the bank.

Apart from the overdue loan book, KBL's standard restructured book increased to 8.07% of standard advances as on December 31, 2021 (one of the highest in the banking sector) from Rs. 1,490 crore (2.97% of standard advances) as on March 31, 2021. A sizeable portion of the restructured book remained under moratorium and the bank witnessed a high level of slippages and overdues from the restructured book that exited the moratorium till December 31, 2021. Accordingly, the performance of the restructured book will remain a key monitorable over the next few years.

The overall stressed assets remained high at ~103% of the core capital as on December 31, 2021 and in relation to peer banks as well. If KBL is unable to reduce these stressed assets, its solvency profile may deteriorate from the level of 25.4% as on December 31, 2021. ICRA believes it is critical for KBL to contain slippages and raise capital to improve its solvency profile.

Muted profitability metrics; unlikely to improve in the near term – KBL's net interest margins (NIMs) remained below the PVBs' average mainly due to the relatively higher cost of funds and the excess liquidity carried by the bank. Despite lower operating costs in comparison to the PVBs' average, the lower share of core fee income remains a drag on KBL's core operating profitability and led to lower core operating profitability compared to the PVBs' average (1.87% of average total assets (ATA) for KBL vs 2.66% for PVBs in 9M FY2022).

³ 12.46% including 9M FY2022 profits

Supported by the hefty treasury gains, the bank was able to accelerate the provisioning on stressed assets in FY2021. Thus, the return on assets (RoA) and return on equity (RoE) remained sub-optimal at 0.57% and 8.26%, respectively, in FY2021 compared to 0.53% and 7.85%, respectively, in FY2020. For 9M FY2022, the core operating profits remained steady and lower slippages resulted in a decline in the credit provisions and steady RoA and RoE of 0.57% and 7.93%, respectively. With expectations of modest operating profitability and pressure on the asset quality, coupled with the moderation in treasury income, the internal capital generation is unlikely to improve in the next couple of years.

High geographical concentration – KBL’s operations are highly concentrated in southern India, which accounted for ~62% of the total exposure (fund based and non-fund based) as on December 31, 2021 (65% as on March 31, 2021). The branches remain concentrated with South India and Karnataka accounting for ~79% and ~63%, respectively, of the total branches as on December 31, 2021. Further, some of the bank’s exposures are large in relation to its core capital. Despite reducing from 165% as on March 31, 2020, the top 20 exposures accounted for 107% of its core capital as on March 31, 2021 and are also high in relation to the peers. ICRA expects KBL’s operations to remain significantly concentrated in southern India over the medium term.

Liquidity position: Strong

KBL’s liquidity profile remains strong with positive cumulative mismatches in the maturity bucket of up to one year. The LCR was comfortable at 288% in Q3 FY2022 (285% in Q3 FY2021), driven by the excess statutory liquidity ratio (SLR) holding of Rs. 4,789 crore or 5.92% of net demand and time liabilities (NDTL) as on February 25, 2022 coupled with the low level of non-operational deposits in total deposits.

KBL’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 KBL’s liquidity profile.

Rating sensitivities

Positive factors – ICRA could upgrade the long-term rating if the bank demonstrates a sustained improvement in its asset quality with a meaningful reduction in stressed exposures. This apart, an improvement in the profitability and solvency ratios with an RoA of more than 1.0%, net stressed assets/core equity of less than 25.0% while maintaining the Tier I capital cushions of over 2% on a sustained basis, would lead to a rating upgrade.

Negative factors – The rating outlook could be revised to Negative or the ratings could be downgraded if there is a deterioration in the asset quality with net stressed assets/core equity exceeding 35%. Additionally, the weakening of the Tier I capital cushions with the same falling below 2% over the regulatory level will be a negative trigger.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA Rating Methodology for Banks
Parent/Group Support	Not Applicable
Consolidation/Standalone	The ratings are based on the consolidated financials of KBL. Moreover, in line ICRA’s limited consolidation approach, the capital requirement of KBL’s subsidiary (KBL Services Limited) has been factored in.

About the company

KBL is a mid-sized old private bank with a market share of 0.5% in advances as on December 31, 2021 in the Indian banking sector. With an asset size of Rs. 90,958 crore as on December 31, 2021, the bank commenced operations in 1924 in Mangalore. As on December 31, 2021, KBL was widely held by public individuals (78.94%), foreign institutional investors and foreign portfolio investors (11.16%), banks/mutual funds (5.64%) and corporate bodies and others (4.27%). It had a network of 859 branches and 915 ATM outlets as on December 31, 2021 with ~79% of its total branches located in South India, indicating a geographically concentrated presence.

Key financial indicators (audited)

Karnataka Bank Limited	FY2020	FY2021	9M FY2021	9M FY2022
Net interest income	2,030	2,183	1,724	1,835
Profit before tax	522	612	570	411
Profit after tax	432	483	451	379
Net advances	56,964	51,694	53,188	55,489
Total assets	82,843	85,116	84,050	90,958
% CET I/Tier I	10.66%	12.34%	11.35%	11.74%
% CRAR	12.66%	14.85%	13.83%	14.15%
% Net interest margin	2.51%	2.60%	2.75%	2.78%
% PAT / ATA	0.53%	0.57%	0.72%	0.57%
% Return on net worth	7.85%	8.26%	10.51%	7.93%
% Gross NPAs	4.82%	4.91%	3.16%	4.13%
% Net NPAs	3.08%	3.18%	1.74%	2.45%
% Provision coverage excl. technical write-offs	37.32%	36.56%	45.86%	41.65%
% Solvency - (NNPA + Net SRs + Net NPIs)/core capital	36.19%	30.45%	20.69%	25.40%

Note: Amount in Rs. crore; All calculations are as per ICRA Research

Total assets and net worth exclude revaluation reserves

Source: KBL, ICRA Research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Current Rating (FY2022)		Chronology of Rating History for the Past 3 Years		
					Date & Rating in FY2022	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020	Date & Rating in FY2019
					Mar-25-2022	Sep-27-2021	Oct-15-2020	Sep-16-2019	Sep-24-2018
1	Lower Tier II Bonds	Long Term	250	250	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)
2	Certificates of Deposit	Short Term	1,500	0	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
3	Basel III Tier II Bonds	Long Term	720	720	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A(hyb) (Stable)	[ICRA]A(hyb) (Stable)	[ICRA]A(hyb) (Stable)
4	Basel III Tier II Bonds	Long Term	300	300	[ICRA]A (Stable)	-	-	-	-

Complexity level of the rated instrument

Instrument	Complexity Indicator
Certificates of Deposit	Very Simple
Lower Tier II Bonds	Simple
Basel III Tier II Bonds	Highly Complex

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: www.icra.in

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE614B08021	Lower Tier II Bonds	November 17, 2012	11.00%	November 17, 2022	250.00	[ICRA]A (Stable)
INE614B08039	Basel III Tier II Bonds*	November 16, 2018	12.00%	November 16, 2028	400.00	[ICRA]A (Stable)
INE614B08047	Basel III Tier II Bonds^	February 18, 2019	12.00%	February 18, 2029	320.00	[ICRA]A (Stable)
Not placed	Basel III Tier II Bonds	-	-	-	300.00	[ICRA]A (Stable)
-	Certificates of Deposit	NA	NA	7-365 Days	1,500.00	[ICRA]A1+

Source: KBL; *Call option due on November 16, 2023; ^ Call option due on February 18, 2024

The subsequent call dates for the above three bonds is on every anniversary of the coupon payment date after the first call option due date and is subject to RBI approval as well as the ability to meet the regulatory capital ratios

Key features of rated debt instruments

The servicing of the Basel II Lower Tier II Bonds and Basel III Tier II Bonds is not subject to any capital ratios and profitability. However, the Basel III Tier II Bonds are 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-2: List of entities considered for consolidated analysis

Company name	Ownership	Consolidation approach
KBL Services Limited	100%	Limited consolidation

Source: KBL

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