March 16, 2023 **(Revised)**

Karnataka Bank Limited: 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Basel II Lower Tier II Bonds	250.00	-	[ICRA]A (Stable); reaffirmed and withdrawn
Basel III Tier II Bonds	1,020.00	1,020.00	[ICRA]A (Stable); reaffirmed
Certificates of Deposit	1,500.00	1,500.00	[ICRA]A1+; reaffirmed
Total	**2,770.00**	**2,520.00**	

**Instrument details are provided in Annexure I*

Rationale

The ratings continue to factor in Karnataka Bank Limited's (KBL) established and granular deposit franchise in southern India, its strong liquidity profile with positive cumulative mismatches across all the less-than-one-year maturity buckets and a high liquidity coverage ratio, as well as the adequate capitalisation profile with Tier I of 13.64% as on December 31, 2022. While the fresh non-performing advances (NPA) generation rate remained at a relatively high level, healthy recoveries and upgrades in recent quarters drove a decline in the credit costs, while the headline asset quality metrics also improved compared to the weaker levels in the past.

Despite the decline in the potential stressed book (overdue loan accounts, i.e. SMA[1] 1 and 2 books and standard restructured advances) during the last one year, it remains sizeable and a key constraining factor for the long-term rating. The bank's ability to reduce its stressed loan book meaningfully will be critical for preventing the weakening of its solvency[2] profile. Furthermore, a sustained improvement in the asset quality levels will be key for keeping the profitability on an improving trajectory, which would minimise KBL's dependence on raising growth capital in the foreseeable future.

Besides this, the ratings are constrained by the significant 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. 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 maintaining the rate of internal capital generation.

ICRA has withdrawn the rating assigned to the Rs. 250-crore Basel II Lower Tier II bonds as these are fully redeemed and no amount is outstanding against the rated instrument. The rating was withdrawn in accordance with ICRA's policy on withdrawal (click here for the policy).

Key rating drivers and their description

Credit strengths

Established regional franchise in Karnataka with granular deposit base – KBL has an established presence of over 98 years in southern India. Its long-standing regional franchise in Karnataka provides it with access to core retail deposits. The share of retail term deposits in total term deposits remained high at 99.6% as on December 31, 2022. As a result, KBL's dependence on bulk deposits remains limited.

[1] Special mention accounts are overdue accounts; SMA-1 are overdue by 31-60 days and SMA-2 are overdue by 61-90 days
[2] Solvency profile = Net stressed assets / Core capital; net stressed assets include net NPAs, net non-performing investments (NPIs) and net security receipts (SRs)

Despite reducing over the last few years, the bank's cost of average interest-bearing funds remained high at 4.66% in 9M FY2023 (same in FY2022) compared to the private banks' (PVBs) average of 3.94% in 9M FY2023 (3.85% in FY2022) on account of the relatively lower share of current account savings account (CASA) deposits in the overall deposit base. However, KBL's CASA ratio of 31.91% as on December 31, 2022 is comparable with similarly-sized peers. Also, in terms of the granularity of deposits, the share of the top 20 deposits in the bank's total deposits remained the lowest among peers at 3.83% as on December 31, 2022.

Adequate capitalisation levels – KBL's capitalisation profile remains adequate with a CET I/Tier I capital ratio of 13.64%[3] as on December 31, 2022 (12.65% as on March 31, 2022) compared to the regulatory requirement of 9.5%. While net advances grew by ~10% over the March 2022 level in 9M FY2023, the growth in the risk-weighted assets (RWA) was lower at ~5%. This was due to the lower risk weight density of segments that have seen stronger growth lately. Besides this, internal capital generation was higher on the back of strong recoveries/upgrades, resulting in lower credit costs. Moreover, the ability to sustain the improvement in the asset quality and profitability levels will be key for generating higher growth capital, although the bank may still consider raising capital in the medium to long term to sustain stronger growth while maintaining the required capital cushions over the regulatory levels.

Credit challenges

Stressed assets remain elevated despite reduction – KBL's fresh NPA generation rate[4] stood at 3.01% (annualised) in 9M FY2023 (3.11% in FY2022), comparatively lower than past levels. This, coupled with meaningful recoveries and upgrades and an increase in the provision coverage, resulted in an improvement in the headline gross NPA (GNPA) and net NPA (NNPA) ratios to 3.28% and 1.66%, respectively, as on December 31, 2022 from 4.13% and 2.45%, respectively, as on December 31, 2021. Notwithstanding this, KBL's overdue book, i.e. SMA-1 and SMA-2 accounts, stood high at 2.99% of the standard advances as on December 31, 2022, though it declined from 4.88% as on December 31, 2021.

Apart from the overdue loan book, KBL's standard restructured book declined to Rs. 3,058 crore (4.97% of standard advances) as on December 31, 2022 from Rs. 4,370 crore (8.07% of standard advances) as on December 31, 2021, though it remains at an elevated level. Moreover, a sizeable portion of this book is still under moratorium and its performance will remain monitorable upon exiting the moratorium in FY2024.

Furthermore, the overall potential stressed assets (SMA-1, SMA-2 and the standard restructured book net of overlap) remained high at 64% of the core capital as on December 31, 2022. KBL's ability to minimise slippages from the potential stressed book, which also remains high in relation to peer banks, will be key for preventing a deterioration in the solvency levels, which stood at 14.6% as on December 31, 2022, and for sustaining the improvement in the profitability levels.

Profitability improves, though sustainability to be seen – Historically, KBL's net interest margins (NIMs) remained below the PVBs' average mainly due to the relatively higher cost of funds and weak credit growth, resulting in the bank carrying excess liquidity. However, the NIM improved in 9M FY2023 to 3.23% (2.82% in FY2022) supported by the improved credit-to-deposit ratio and the lagged repricing of deposits vis-à-vis advances amidst rising interest rates. Despite lower operating costs compared to the PVBs' average, the lower share of core fee income remains a drag on KBL's core operating profitability, which was below the PVBs' average (2.39% of average total assets (ATA) for KBL vs 3.06% for PVBs in 9M FY2023). Further, stronger recoveries and upgrades during FY2022-9M FY2023 helped keep the overall credit costs at 0.7% of ATA against 1.4-1.6% in previous years. However, considering the sizeable stressed book, the ability to keep slippages at lower levels and sustain strong recoveries will be key for containing the credit costs and sustaining the improvement in the return on assets (RoA) and return on equity (RoE). The RoA and RoE stood at 1.15% and 15.76%, respectively, in 9M FY2023 compared to 0.58% and 7.66%, respectively, in FY2022 and remained below the PVBs' average.

High geographical concentration – KBL's operations are highly concentrated in southern India, which accounted for ~61% of the total exposure (fund based and non-fund based) as on December 31, 2022 (62% as on December 31, 2021). The branches remain concentrated with South India and Karnataka accounting for ~76% and ~64%, respectively, of the total branches as

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[3] *Including 9M FY2023 profits*

[4] *Fresh NPA generation – Gross fresh slippages/opening standard advances*

on December 31, 2022. Further, some of the bank's exposures are large in relation to its core capital. The top 20 exposures accounted for 129% of its core capital as on March 31, 2022, up from 107% 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.

Environmental and social risks

While banks like KBL do not face 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 KBL 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 lesser 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. KBL has not faced material lapses over the years. Customer preferences are increasingly shifting towards digital banking, which provides an opportunity to reduce the operating costs. KBL has been 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

KBL's strong liquidity profile is supported by the excess statutory liquidity ratio (SLR) holding of 7.2% of net demand and time liabilities (NDTL) as on September 23, 2022, coupled with the low level of non-operational deposits in total deposits, resulting in positive cumulative mismatches in the maturity bucket of up to one year. Furthermore, the LCR was comfortable at 291% in Q3 FY2023 while the net stable funding ratio (NSFR) stood at 106% against the regulatory ask of 100% as on December 31, 2022.

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%, while ensuring that net stressed assets/core equity remains less than 25.0% and Tier I capital cushions remain 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's Rating Methodology for Banks and Financial Institutions ICRA's Policy on Withdrawal of Credit Ratings ICRA's Rating Methodology on Consolidation
Parent/Group support	Not Applicable
Consolidation/Standalone	The ratings are based on KBL's consolidated financials. 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 private bank with a market share of 0.5% in advances as on December 31, 2022 in the Indian banking sector. It commenced operations in 1924 in Mangalore. With an asset size of Rs. 1.00 lakh crore as on December 31, 2022, KBL is widely held by public individuals (67.19%), foreign institutional investors and foreign portfolio investors (19.76%), banks/mutual funds (5.43%) and corporate bodies and others (7.62%). It had a network of 885 branches and 879 ATM outlets as on December 31, 2022 with ~76% of its total branches located in South India, indicating a geographically concentrated presence.

Key financial indicators (standalone)

Karnataka Bank Limited	FY2021	FY2022	9M FY2022	9M FY2023
Net interest income	2,183	2,491	1,835	2,325
Profit before tax	612	695	411	1,009
Profit after tax	483	509	379	826
Net advances (Rs. lakh crore)	0.52	0.57	0.55	0.63
Total assets (Rs. lakh crore)	0.85	0.92	0.91	1.00
CET I	12.34%	12.65%	12.51%*	13.64%*
Tier I	12.34%	12.65%	12.51%*	13.64%*
CRAR	14.85%	15.66%	14.92%*	16.57%*
Net interest margin / ATA	2.60%	2.82%	2.78%	3.23%
PAT / ATA	0.57%	0.58%	0.57%	1.15%
Return on net worth	8.26%	7.66%	7.93%	15.76%
Gross NPAs	4.91%	3.90%	4.13%	3.28%
Net NPAs	3.18%	2.42%	2.45%	1.66%
Provision coverage excl. technical write-offs	36.56%	38.82%	41.65%	49.26%
Net NPA / Core equity capital	30.45%	21.00%	25.40%	14.08%

*Source: KBL, ICRA Research; All ratios as per ICRA's calculations; Amount in Rs. crore unless mentioned otherwise; * Includes 9M profits*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

		Current rating (FY2023)				Chronology of rating history for t		
		Type	Amount rated	Amount outstanding as of Mar 15, 2023	Date & rating in FY2023	Date & rating in FY2022		Date & rati FY2021
			(Rs. crore)	(Rs. crore)	Mar-16-2023	Mar-25-2022	Sep-27-2021	Oct-15-20
1	**Basel III Tier II Bonds**	Long Term	1,020.00	1,020.00	**[ICRA]A (Stable)**	**[ICRA]A (Stable)**	**[ICRA]A (Stable)**	**[ICRA]A (h (Stable**
2	**Basel II Lower Tier II Bonds**	Long Term	250.00	-	**[ICRA]A (Stable); Reaffirmed and withdrawn**	**[ICRA]A (Stable)**	**[ICRA]A (Stable)**	**[ICRA]A (Stable**
3	**Certificates of Deposit**	Short Term	1,500.00	400.00^	**[ICRA]A1+**	**[ICRA]A1+**	**[ICRA]A1+**	**[ICRA]A1**

^ *Balance amount yet to be placed*

Complexity level of the rated instruments

Instrument	Complexity Indicator
Basel III Tier II Bonds	Highly Complex
Basel II Lower Tier II Bonds	Simple
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
INE614B08021	**Basel II Lower Tier II Bonds**	Nov-17-2012	11.00%	Nov-17-2022	250	[ICRA]A (Stable); withdrawn
INE614B08039	**Basel III Tier II Bonds**	Nov-16-2018	12.00%	Nov-16-2028*	400	[ICRA]A (Stable)
INE614B08047	**Basel III Tier II Bonds**	Feb-18-2019	12.00%	Feb-18-2029^	320	[ICRA]A (Stable)
INE614B08054	**Basel III Tier II Bonds**	Mar-30-2022	10.70%	Mar-30-2032#	300	[ICRA]A (Stable)
INE614B16719	**Certificates of Deposit**	Dec-14-2022	12.00%	Mar-15-2023	400	[ICRA]A1+
NA	**Certificates of Deposit**	NA	NA	NA	1,100	[ICRA]A1+

Source: KBL; CD outstanding as on March 15, 2023

**Call option due on November 16, 2023; ^ Call option due on February 18, 2024; # Call option due on March 30, 2027*

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

Key features of rated debt instruments

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 II: List of entities considered for limited consolidated analysis

Company Name	Ownership	Consolidation Approach
KBL Services Limited	100%	Limited consolidation

Source: KBL

Corrigendum

Rationale dated March 16, 2023, has been revised with changes as below:

- Addition of "ICRA's Rating Methodology on Consolidation" in the analytical approach section

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About ICRA Limited:

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