January 13, 2025(Revised)

Karnataka Bank Limited: Long-term rating upgraded, short-term rating reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Tier II Bonds	300.00	300.00	[ICRA]A+ (Positive); upgraded from [ICRA]A (Positive)
Basel III Tier II Bonds	320.00	0.00	[ICRA]A+ (Positive); upgraded from [ICRA]A (Positive) and withdrawn
Certificates of Deposit	1,500.00	1,500.00	[ICRA]A1+; reaffirmed
Total	**2,120.00**	**1,800.00**	

**Instrument details are provided in Annexure I*

Rationale

The rating upgrade factors in the sustained improvement in Karnataka Bank Limited's (KBL) earnings profile, driven by the higher credit growth, and improvement in capital buffers, which were also supported by the equity capital raise in FY2024. Though the net interest margin (NIM) declined in FY2024 and H1 FY2025, the bank was able to maintain a healthy return on assets (RoA), supported by low credit costs. The maintenance of the Positive outlook on the long-term rating reflects ICRA's expectation that KBL will be able to maintain steady credit growth and comfortable solvency[1] and profitability metrics.

The ratings also continue to factor in the bank's 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 (LCR). Further, its comfortable capitalisation profile with Tier I capital of 15.93%[2] as on September 30, 2024, supports the ratings. While KBL had raised equity capital in FY2024, which has added to its existing capital cushions, the impact of transitioning to provisioning, based on the expected credit loss (ECL) framework, on the capital and profitability levels will remain a monitorable.

ICRA also notes the continued improvement in the bank's headline asset quality metrics and the declining share of vulnerable loans {overdue loan accounts, i.e. SMA[3] accounts (SMA-1 and SMA-2), standard restructured advances}, which formed ~4% of the standard advances as on September 30, 2024. The performance of the residual vulnerable book would remain a near-to-medium term monitorable, especially in the backdrop of persisting high interest rates, geopolitical issues and concerns around overleveraging among retail borrowers. The ability to keep the asset quality under control despite the expected increase in slippage rates will be key for maintaining the healthy profitability profile and sufficient capital cushions in the foreseeable future. The ratings also consider the steep decline in the daily average LCR to 144% in Q2 FY2025 from 269% in Q1 FY2025 as the recalibration of LCR computation, following the suggestions made by the regulator, resulted in higher outflows. Besides this, the ratings are constrained by the significant regional concentration of KBL's operations as well as the high share of its top exposures, in relation to the core capital, compared to peer banks.

ICRA has withdrawn the rating assigned to the Rs. 320-crore Basel III Tier II bonds as these are fully redeemed and no amount is outstanding against the same. The rating was withdrawn in accordance with ICRA's policy on the withdrawal of credit ratings (click here for the policy).

[1] Solvency is defined as {(Net NPAs + Net security receipts + Net non-performing investments)/Core capital}

[2] Excluding profit for 6M FY2025

[3] 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 (SMA-1 and SMA-2) is for the entire bank, including exposures below Rs. 5 crore

Key rating drivers and their description

Credit strengths

Established regional franchise in Karnataka with granular deposit base – KBL has an established presence of over 100 years in the 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. As a result, KBL's dependence on bulk deposits remains limited. 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 3.74% as on March 31, 2024 (3.55% as on March 31, 2023).

Notwithstanding the above, the relatively lower share of current accounts and savings account (CASA) deposits in the overall deposit base (31% as on September 30, 2024) vis-à-vis the banking sector average (37%) resulted in a comparatively higher cost of interest-bearing funds. The bank's cost of average interest-bearing funds remained higher at 5.42% in 6M FY2025 (5.22% in FY2024) against the banking sector average of 5.32% (annualised).

Comfortable capitalisation levels – KBL's capitalisation profile remains comfortable with a CET I/Tier I capital ratio of 15.93%[4] as on September 30, 2024 (13.11%[4] as on September 30, 2023), which remains comfortable compared to the regulatory requirement of 9.50%. The capitalisation levels were supported by the equity capital raise of Rs. 1,500 crore in FY2024, which will aid its growth plans for the medium term. ICRA expects KBL to maintain comfortable capital cushions over and above the regulatory requirements as well as the negative triggers.

Profitability improves– Historically, KBL's NIM remained below the private sector banks' (PVBs) average, mainly due to the high share of low-yield advances (including large exposures to strong corporates as well as deposits against the shortfall to meet priority sector lending targets), the relatively higher cost of funds and the comparatively weaker credit growth. Despite lower operating costs compared to the PVB average, the lower share of core fee income[5] (0.89% of average total assets (ATA) for KBL vs 1.44% for PVBs in H1 FY2025) remains a drag on KBL's core operating profitability[5], which was below the PVB average (1.70% of ATA for KBL vs 2.76% for PVBs in H1 FY2025). However, the decline in the credit costs to 0.1% of ATA (annualised) in 6M FY2025 from 0.5-1.6% during FY2018-FY2024 supported the profitability.

Nevertheless, given the concerns around overleveraging in the retail segment, the persisting elevated interest rate environment and the prevalent geopolitical issues, the ability to keep slippages at lower levels and sustain strong recoveries will be key for containing the credit costs and maintaining the healthy RoA and return on average equity (RoE), which increased to annualised 1.27% and 13.15%, respectively, in 6M FY2025 from 1.21% and 13.71%, respectively, in FY2024.

Credit challenges

Asset quality remains a monitorable – KBL's fresh non-performing advances (NPA) generation rate[6] moderated to 1.87% (annualised) in 6M FY2025 from 2.80% in FY2024 (3.31% in FY2023), though it remained marginally above the PVB average (1.71% in 6M FY2025). With recoveries and upgrades and the increase in the loan book, the headline gross NPA (GNPA) and net NPA (NNPA) ratios improved to 3.21% and 1.46%, respectively, as on September 30, 2024, from 3.53% and 1.58%, respectively, as on March 31, 2024. Notwithstanding this, KBL's overdue book, i.e. SMA-1 and SMA-2, stood at 2.67% of the standard advances, as on September 30, 2024, despite decreasing from 3.43% as on September 30, 2023, while the standard restructured book stood at Rs. 1,268 crore (1.74% of standard advances) as on September 30, 2024 compared to Rs. 2,214 crore (3.43% of standard advances) as on September 30, 2023. Accordingly, the overall potential vulnerable loans (SMA-1, SMA-2 and the standard restructured book, net of overlap) remained high at 32% of the core capital, as on September 30, 2024, despite moderating from 58% as on December 31, 2023. KBL's ability to minimise slippages from the potential vulnerable book, which also remains high compared to peer banks, will be key for ensuring a continued improvement in its profitability levels and for maintaining the solvency at a comfortable level.

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[4] *Excluding 6M profit*
[5] *Excludes trading gains*
[6] *Fresh NPA generation – Gross Fresh slippages/Opening Standard Advances*

High geographical concentration – KBL's operations remain highly concentrated with South India and Karnataka accounting for ~79% and ~63%, respectively, of the total branches as on September 30, 2024. This exposes the bank to local and socio-economic and political risks. ICRA expects KBL's operations to remain regionally concentrated with the same unlikely to improve in the near-to-medium term. Further, some of the bank's exposures are large in relation to its core capital. KBL's top 20 exposures accounted for 121% of the core capital as on March 31, 2024, remaining high compared to peers, despite moderating from 124% as on March 31, 2023. However, ICRA notes that these large exposures are to corporates with strong credit profiles and for deploying excess liquidity; KBL's ability to redeploy these funds towards granular loan segments will be a driver of improved profitability.

Environmental and social risks

While banks like KBL do not face material physical climate risks, they are exposed to environmental risks indirectly through their asset portfolio. If the entities or businesses, to which banks and financial institutions have exposure, face business disruptions because of physical climate adversities or if they face climate transition risks because of technological, regulatory or customer behaviour changes, the same could translate into credit risks for banks. However, such risks are 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 fewer downside environmental risks.

With regard to social risks, data security and customer privacy are among the key sources of vulnerability for banks as material lapses could be detrimental to their reputation and invite regulatory censure. KBL has not faced such lapses over the years, which highlights its sensitivity to such risks. It is seen to be operating responsibly in terms of its selling practices, with no instances of fines being imposed by the regulatory authorities because of misconduct. Customer preference is increasingly shifting towards digital banking, which provides an opportunity to reduce operating costs. KBL has been at the forefront of making the requisite investments to enhance its digital interface with its customers. While it contributes to promoting financial inclusion by lending to the underserved 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 surplus statutory liquidity ratio (SLR) holding of 4.3% of net demand and time liabilities (NDTL) as on November 1, 2024, over and above the regulatory ask of 18%, resulting in positive cumulative mismatches in the maturity buckets of up to one year. The bank's LCR declined to 144% in Q2 FY2025 from 269% in Q1 FY2025, following the recalibration of its LCR computation in line with instructions by the regulator, though the same remains comfortable. The net stable funding ratio (NSFR) stood at 135% in Q2 FY2025, which was well above the regulatory ask of 100%. 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 rating if the bank is able to maintain the profitability with an RoA of more than 1.0% and ensuring that its Tier I capital cushions remain above 3% while increasing the geographical diversification of its assets and liability base.

Negative factors – Deterioration in the asset quality with the solvency exceeding 30% or the RoA below 0.8% would be a negative factor. Additionally, the weakening of the Tier I capital cushions with the same falling below 2% over the regulatory level or a deterioration in the liability franchise will be negative triggers.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	ICRA's Rating Methodology for Banks and Financial Institutions ICRA's Rating Methodology on Consolidation 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 KBL. However, in line with ICRA's consolidation approach, the standalone assessment of the bank factors in the ordinary and extraordinary support that it is expected to extend to its subsidiary.

About the company

KBL is a mid-sized private bank set up in 1924 in Mangalore. It had a market share of 0.4% in advances in the Indian banking sector as on September 30, 2024. With an asset size of Rs. 1.16 lakh crore as on September 30, 2024, KBL is widely held by public individuals (59.7%), domestic institutions (22.1%), foreign institutional investors and foreign portfolio investors (10.3%), and corporate bodies and others (7.9%). It had a network of 931 branches and 1,505 ATM outlets as on September 30, 2024 with ~79% of its total branches located in South India.

Key financial indicators (standalone)

Karnataka Bank Limited	FY2023	FY2024	6M FY2025
Total income	4,341	4,504	2,255^
Profit after tax	1,180	1,306	736
Total assets (Rs. lakh crore)	0.99	1.16	1.16
CET I	14.18%	16.17%	15.93%*
CRAR	17.45%	18.00%	17.58%*
PAT / ATA	1.24%	1.21%	1.27%
Gross NPAs	3.74%	3.53%	3.21%
Net NPAs	1.70%	1.58%	1.46%

*Source: KBL, ICRA Research; All ratios as per ICRA's calculations; Amount in Rs. crore unless mentioned otherwise; ^Excludes exchange profit; * Excludes 6M profit*
Total income = Net interest income + Non-interest income (excluding trading gains)

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

Current (FY2025)				Chronology of Rating History for the Past 3 Years					
				FY2024		FY2023		FY2022	
Instrument	Type	Amount Rated (Rs. crore)	Jan 13, 2025	Date	Rating	Date	Rating	Date	Rating
Basel III Tier II Bonds	Long term	300.00	[ICRA]A+ (Positive)	02-Feb-24	[ICRA]A (Positive)	16-Mar-23	[ICRA]A (Stable)	25-Mar-22	[ICRA]A (Stable)
				-	-	-	-	27-Sep-21	[ICRA]A (Stable)
Basel III Tier II Bonds	Long term	320.00	[ICRA]A+ (Positive); Withdrawn	02-Feb-24	[ICRA]A (Positive)	16-Mar-23	[ICRA]A (Stable)	25-Mar-22	[ICRA]A (Stable)
				-	-	-	-	27-Sep-21	[ICRA]A (Stable)
Basel III Tier II Bonds	Long term	-	-	02-Feb-24	[ICRA]A (Positive); Withdrawn	16-Mar-23	[ICRA]A (Stable)	25-Mar-22	[ICRA]A (Stable)
				-	-	-	-	27-Sep-21	[ICRA]A (Stable)
Certificates of Deposit	Short term	1,500.00	[ICRA]A1+	02-Feb-24	[ICRA]A1+	16-Mar-23	[ICRA]A1+	25-Mar-22	[ICRA]A1+
				-	-	-	-	27-Sep-21	[ICRA]A1+

Complexity level of the rated instruments

Instrument	Complexity Indicator
Basel III Tier II Bonds	Highly Complex
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
INE614B08047	**Basel III Tier II Bonds**	Feb-18-2019	12.00%	Feb-18-2029*	320	[ICRA]A+ (Positive); withdrawn
INE614B08054	**Basel III Tier II Bonds**	Mar-30-2022	10.70%	Mar-30-2032^	300	[ICRA]A+ (Positive)
NA	**Certificates of Deposit**	NA	NA	NA	1,500	[ICRA]A1+

Source: KBL; CD outstanding was NIL as on January 02, 2025

**Call option exercised; ^ First call option due on March 30, 2027, with the subsequent call dates on every anniversary of the coupon payment date and is subject to RBI approval as well as KBL's ability to meet the regulatory capital ratio requirements*

Key features of rated debt instruments

The servicing of the rated certificates of deposit is not contingent on the capital ratios or the bank's 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. These 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 consolidated analysis

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

Source: KBL

Corrigendum

Rationale dated January 13, 2025, has been corrected with revisions as detailed below:

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

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