October 15, 2020

Karnataka Bank Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Lower Tier II Bonds	250.00	250.00	[ICRA]A(Stable); reaffirmed
Basel III Tier-II Bonds	720.00	720.00	[ICRA]A(hyb)(Stable); reaffirmed
Certificates of deposit	3,000.00	3,000.00	[ICRA]A1+; reaffirmed
Total	**3,970.00**	**3,970.00**	

**Instrument details are provided in Annexure-1*

Rationale

The ratings reaffirmation considers 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. Despite being granular, the cost of interest-bearing funds for the bank remains marginally higher than the private bank (PVB) average because of the relatively low share of current accounts and savings account (CASA) deposits in total deposits, even though it remains comparable to similarly-sized peers. Further, KBL has a strong liquidity profile with positive cumulative mismatches (adjusted for moratorium) across all the maturity buckets in the less-than-one-year category and a high liquidity coverage ratio[1] (LCR) of 232.62% as on June 30, 2020. The ratings are supported by the bank's adequate capitalisation with Tier I of 11.07% as on June 30, 2020, even though its solvency[2] profile has been weakening over the last few years given the increasing level of net stressed assets. The ratings are also constrained by the high regional concentration of the bank's operations as well as the high share of the top exposures in relation to the core capital.

KBL's asset quality indicators have been average with a high fresh slippage rate of 3.8% of standard advances in FY2020 (3.2% in FY2019) though the large write-offs supported the reported gross non-performing advances (GNPAs) of 4.6% as on June 30, 2020. With high slippages during the last few years, KBL's solvency profile continued to weaken to 36.2% as on March 31, 2020 compared to 29.0% as on March 31, 2017. The share of the loan book under moratorium (~51.15% by value as on June 30, 2020) remains high for KBL compared to peer banks and the near-term uncertainty regarding the asset quality remains high. High slippages have also resulted in high credit costs, thereby negatively impacting the bank's profitability and leading to weak internal capital generation.

Given the uncertainty regarding the asset quality, ICRA expects that the bank should raise capital to improve its cushion to absorb the losses and the solvency levels. As per ICRA's estimates, KBL would need equity capital of ~Rs. 600-800 crore in the near term to maintain a sufficient Tier I capital cushion and to improve its solvency profile. With weak equity valuation, KBL might face challenges in raising capital in the current market conditions and this

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[1] *Against the RBI guidelines of LCR requirement of 90% from October 1, 2020 to March 31, 2021 and 100% from April 1, 2021*

[2] *Solvency is defined as net stressed assets/core capital; net stressed assets include net non-performing advances (NPAs), net non-performing investments and net security receipts issued against the sale of NPAs*

remains a monitorable. Additionally, ICRA will continue to monitor the bank's asset quality profile and its ability to reduce the loan book under moratorium. Further weakening in the solvency profile from the current level or in the capital cushions could result in a Negative outlook or a rating downgrade.

Key rating drivers and their description

Credit strengths

Established regional franchise in Karnataka – KBL has an established presence in southern India of over 95 years. Its long-standing regional franchise in Karnataka provides access to core retail deposits. The share of retail term deposits remained high at 71.3% as on June 30, 2020. As a result, KBL's dependence on bulk deposits remains limited. Despite the high share of retail term deposits, the bank's cost of average interest-bearing funds remained higher at 6.0% in FY2020 compared to the PVBs' average of 5.4%. This was mainly due to the low share of CASA deposits (28.7% of the total deposits) as on June 30, 2020. However, on comparison with similarly-sized peers, ICRA notes that KBL's CASA ratio is comparable to its peers. With a view to increase its CASA share, the bank is focusing on the trusts, associations, societies and co-operatives (TASC) segment, which has witnessed good traction. This is also evident from the various trusts and societies appearing in the top 20 depositors list. 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 3.4% as on March 31, 2020.

Adequate capitalisation levels; however, capital required in near term to improve Tier I cushion against possible asset quality stress – KBL's capitalisation profile remains adequate but at the lower end of its peer banks with a Tier I capital ratio of 11.07% as on June 30, 2020 compared to the regulatory requirement of 9.5% by April 1, 2021. As per ICRA's estimates, the bank will require ~Rs. 600-800 crore (46-62% of its market capitalisation) to maintain a Tier I capital cushion of over 2.0% above the regulatory requirement while improving its solvency profile. KBL has shareholders' approval to raise capital with the total number of equity shares to be issued not exceeding 15 crore. Given the depressed equity valuation multiples and the large capital requirement in relation to its current market capitalisation, the mode of capital raising remains a monitorable. ICRA could assign a Negative outlook or downgrade the ratings if the asset quality stress increases because of the Covid-19 pandemic-induced economic slowdown and if there is a delay in raising capital, thereby leading to further weakening of the solvency profile.

Credit challenges

Uncertainty regarding asset quality pressure likely to remain in near term as high share of loan book is under moratorium; material improvement in solvency profile not expected in near to medium term – KBL's gross advances under moratorium remained high at 51.15% (in terms of value) as on June 30, 2020. Further, the bank's loan book under moratorium is higher compared to peer PVBs, indicating near-term uncertainty regarding the asset quality. The externally-rated loan book accounted for ~13.1% of the total advances under moratorium as on June 30, 2020, indicating that the rest of the loan book under moratorium is from smaller accounts. ICRA notes that the advances externally rated in the D category are progressively becoming NPAs during the last few years and loans under moratorium in this category stood at 0.8% of standard advances. In addition, standard advances externally rated in the BB, B and C categories accounted for 2.5% of standard advances as on June 30, 2020. Cumulatively, standard advances in the BB and below category are 3.4% of standard advances as on June 30, 2020 and represent a potential source of stress in the near term. Further, the share of the gross loan book rated BB and below has consistently increased in the last few years, indicating weakening in the quality of the loan book. As on June 30, 2020, KBL undertook asset classification benefit for loans amounting to Rs. 970 crore (1.8% of standard advances) and has provided a Covid-19 provision of Rs. 97 crore as per the Reserve Bank of India's (RBI) guidelines.

KBL's asset quality indicators have been average with a high fresh slippage rate of 3.8% of standard advances in FY2020 (3.2% in FY2019). Despite the high slippages, the reported GNPA ratio has been supported by the high write-offs undertaken by the bank during the last few years. Write-offs, as a percentage of opening GNPAs, stood at 44.4% in FY2020 compared to 37.8% in FY2019. Including write-offs, the GNPA ratio would have increased to 6.7% in FY2020 from 5.4% in FY2017. Though KBL's provision coverage ratio, including write-offs, has been improving (67.93% as on June 30, 2020 compared to 54.0% as on March 31, 2017) and is almost comparable with peer PVBs, its solvency profile has continued to weaken with high slippages. The net stressed assets/core capital weakened to 36.2% as on March 31, 2020 from 29.0% as on March 31, 2017. ICRA believes it will be critical for the bank to contain slippages and raise capital to improve its solvency profile.

Muted profitability metrics; unlikely to improve in near term – Despite a cut of ~200 bps in the 1-year term deposit rates between April 2019 and August 2020, the cost of funds remains sticky for the bank, leading to limited improvement in its net interest margins (NIMs). KBL's NIMs remained below the PVBs' average mainly due to its high leverage of ~13.3 times as on June 30, 2020 compared to the PVBs' average of ~8.0 times as on June 30, 2020 and the high slippages in the past. Though the bank's operating expenses, as a percentage of the average total assets (ATA), are comparable to the PVBs' average, the weaker NIMs and lower share of non-interest income result in a high cost-to-income ratio (58.5% in FY2020). This leads to a weak core operating profitability compared to the PVBs' average (1.56% of ATA for KBL vs 2.7% for PVBs in FY2020). This, coupled with the asset quality pressure, limits the bank's ability to aggressively provide against its stressed assets. KBL's net profitability also remains average with a return on assets (RoA) and a return on equity (RoE) of 0.53% and 7.85%, respectively, in FY2020 and 0.64% and 8.88%, respectively, in FY2019. Given the uncertainty regarding the asset quality as well as 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 with an expected RoA of <0.5-0.6% for the next couple of years.

High concentration – KBL's operations are highly concentrated in southern India, which accounted for ~60% (as on March 31, 2020) of the total credit. The branches remain concentrated with South India accounting for ~78% of the total branches and Karnataka accounting for ~62% of the total branches as on June 30, 2020. ICRA expects the bank's operations to remain highly concentrated in southern India over medium term. Further, some of the bank's exposures are large in relation to its core capital, and the top 20 exposures accounted for 165% of its core capital as on March 31, 2020 compared to 174% as on March 31, 2019. This exposes KBL's capital and profitability to the performance of these large accounts and the management has guided towards reducing these large-ticket exposures.

Liquidity position: Strong

After factoring in the moratorium on advances, KBL's liquidity profile remains strong with positive cumulative asset-liability gaps in the maturity bucket of up to one year (as on July 12, 2020). The LCR was comfortable at 232.6% as on June 30, 2020, driven by its excess SLR (fortnightly average of ~3.0% of net demand and time liabilities) 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 (currently ~85%). In addition, access to call money markets and the RBI's repo and marginal standing facility (MSF) in case of urgent liquidity needs aid KBL's liquidity profile.

Rating sensitivities

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

Negative triggers – The bank's ratings could face pressure in case of a deterioration in the asset quality with net stressed assets/core equity exceeding 35% and on the weakening of the Tier I capital cushions over the regulatory level with the same falling below 2%.

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 standalone financials of KBL

About the company

KBL is a mid-sized old private bank with a market share of ~0.6% in advances in the Indian banking sector. With an asset size of Rs. 82,658 crore as on June 30, 2020, the bank commenced operations in 1924 in Mangalore. As on June 30, 2020, KBL was widely held by public individuals (71.7%), foreign institutional investors and foreign portfolio investors (8.7%), banks/mutual funds (8.7%) and corporate bodies and others (10.8%). It had a network of 858 branches and 1,024 ATM outlets as on June 30, 2020 with ~78% of its total branches located in South India, indicating a geographically concentrated presence.

Key financial indicators

	FY2019	FY2020	Q1 FY2020	Q1 FY2021
Net interest income	1,905	2,030	495	535
Profit before tax	608	522	149	168
Profit after tax	477	432	175	196
Net advances	54,828	56,964	52,819	54,210
Total assets (excluding revaluation reserves)	78,634	82,843	78,537	82,658
%Tier I	11.2%	10.7%	10.7%	11.1%
% CRAR	13.2%	12.7%	12.7%	13.1%
%Net interest margin / Average total assets	2.6%	2.5%	2.5%	2.6%
%Net profit / Average total assets	0.6%	0.5%	0.9%	0.9%
%Return on net worth	8.9%	7.8%	12.8%	14.0%
% Gross NPAs	4.4%	4.8%	4.6%	4.6%
% Net NPAs	3.0%	3.1%	3.3%	3.0%
% Provision coverage excl. technical write-offs	34.2%	37.3%	27.8%	36.2%
% Net NPA / Core capital	30.2%	31.2%	32.9%	28.2%

Amounts in Rs. crore
Quarterly results are unaudited while annual results are audited
Source: Karnataka Bank Limited, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2021)				Rating History for the Past 3 Years				
		Type	Amount Rated	Amount Outstanding	Rating	FY2020	FY2019	FY2018		
					15-Oct-2020	16-Sep-2019	24-Sep-2018	21-Mar-2018	16-Feb-2018	26-Jul-2017
1	Lower Tier-II Bonds	Long Term	250.0	250.0	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)
2	Certificates of Deposit	Short Term	3,000.0	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
3	Basel III Compliant Tier II Bonds	Long Term	720.0	720.0	[ICRA]A(Hyb) (Stable)	[ICRA]A(Hyb) (Stable)	[ICRA]A(Hyb) (Stable)	-	-	-

Amount in Rs. crore

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the 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	17-11-2012	11.00%	17-11-2022	250.00	[ICRA]A(Stable)
INE614B08039	Basel III Tier II Bonds	16-11-2018	12.00%	16-11-2028	400.00	[ICRA]A(hyb)(Stable)
INE614B08047	Basel III Tier II Bonds	18-02-2019	12.00%	18-02-2029	320.00	[ICRA]A(hyb)(Stable)
-	Certificates of Deposit	NA	NA	7-365 Days	3,000.00	[ICRA]A1+

Source: Karnataka Bank Limited

Annexure-2: List of entities considered for consolidated analysis – Not Applicable

Analyst Contacts

Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Anil Gupta
+91 124 4545 314
anilg@icraindia.com

Niraj Jalan
+91 33 7150 1146
niraj.jalan@icraindia.com

Aayush Behal
+91 124 4545 300
aayush.behal@icraindia.com

Relationship Contact

Jayanta Chatterjee
+91 80 4332 6401
jayantac@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries:

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

ICRA Limited

Corporate Office
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300
Email: info@icraindia.com
Website: www.icra.in

Registered Office
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

Mumbai	+ (91 22) 24331046/53/62/74/86/87
Chennai	+ (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,
Kolkata	+ (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,
Bangalore	+ (91 80) 2559 7401/4049
Ahmedabad	+ (91 79) 2658 4924/5049/2008
Hyderabad	+ (91 40) 2373 5061/7251
Pune	+ (91 20) 2556 0194/ 6606 9999