Karnataka Bank Limited (Revised)

August 23, 2023

Facilities/Instruments	Amount (₹ crore)	Rating[1]	Rating Action
Basel III Compliant Tier-II Bonds #	720.00	CARE A; Stable	Reaffirmed
Basel III Compliant Tier-II Bonds #	300.00	CARE A; Stable	Reaffirmed
Lower Tier-II Bonds	-	-	Withdrawn

Details of instruments/facilities in Annexure-1.

#Tier-II Bonds under Basel III are characterised by a 'Point of Non-Viability' (PONV) trigger due to which the investor may suffer a loss of principal. PONV will be determined by the Reserve Bank of India (RBI) and is a point at which the bank may no longer remain a going concern on its own unless appropriate measures are taken to revive its operations, and thus, enable it to continue as a going concern. In addition, the difficulties faced by a bank should be such that these are likely to result in financial losses and raising Common Equity Tier-I capital of the bank should be considered as the most appropriate way to prevent the bank from turning non-viable. In CARE Ratings Limited's (CARE Ratings') opinion, the parameters considered to assess whether a bank will reach the PONV are similar to the parameters considered to assess the rating of Tier-II instruments even under Basel II. CARE Ratings has rated the Tier-II bonds under Basel III after factoring in the additional feature of PONV.

Rationale and key rating drivers

The rating assigned to the bond issues of Karnataka Bank Limited (KBL) continues to factor in its long and established operational track record of 10 decades, adequate capitalisation levels, consistent profitability with improvement seen in FY23 (refers to the period April 01 to March 31) and its sticky and granular retail deposit base with stable current account saving account (CASA) deposit share.
The rating is, however, constrained by the bank's relatively small size, substantial regional concentration with top five states contributing to 82.6% of gross advances as on March 31, 2023 and moderate asset quality parameters. CARE Ratings takes note of the fact that major portion of restructured loans outstanding will be coming out of moratorium and satisfactory performance of the same is critical for improving asset quality further.

Rating sensitivities: Factors likely to lead to rating actions

Positive factors- Factors that could, individually or collectively, lead to positive rating action/upgrade

- Improvement in CET I Ratio on a sustained basis.
- Maintenance of net stressed assets/ net worth < 50% on a sustained basis along with improvement in asset quality position.

Negative factors- Factors that could, individually or collectively, lead to negative rating action/downgrade

- Material deterioration in asset quality (gross non-performing asset [GNPA]>7.5%) impacting earnings profile of the bank.
- Inability to maintain sufficient cushion over the regulatory capital.

Analytical approach:

Standalone

Outlook: Stable

CARE Ratings believes that the entity shall sustain its business and financial risk profile with credit cost under control over the medium term.

Detailed description of the key rating drivers:

Key strengths

Long operational track record

Established in the year 1924, KBL has a proven track record of over nine decades in financial services. Over the years, it has developed a strong deposit base in the state of Karnataka and in its adjoining states like Maharashtra, Andhra Pradesh, and Tamil Nadu. Srikrishnan H (Managing Director and CEO; w.e.f. from June 09, 2023) has nearly four decades of industry experience in

[1]Complete definition of the ratings assigned are available at www.careedge.in and other CARE Ratings Ltd.'s publications

banking. He is assisted by a team of General Managers heading various departments. KBL has a network of 901 branches, 1,474 ATMs & Recyclers spread across 22 states and two Union Territories along with an employee base of 8,652 employees as on March 31, 2023.

Adequate capitalisation levels

Aided by steady profit accretion, the bank's total capital adequacy ratio (CAR) and Tier-I CAR improved to 17.45% and 14.18%, respectively, as on March 31, 2023, as against 15.66% and 12.65% as on March 31, 2022. CAR% and Tier-I CAR% of the bank stood at 17.00% and 13.80%, respectively, as on June 30, 2023 excluding profits for the quarter and remains adequately above the regulatory requirements.
CARE Ratings expects the current capitalisation would be adequate to support the growth over the near term. Although the bank is also in the process of obtaining Board approval to raise capital via qualified institutional placement (QIP), given its low equity valuation, the bank's ability to raise funds would be monitored.

Consistent profitability with improvement witnessed in FY23

The net interest margin (NIM) of the Bank witnessed improvement from 2.84% in FY22 to 3.37% in FY23 resulting from healthy increase of net interest income by 27.9% aided by increase in yields. As significant portion of the interest rate on advances was linked to external benchmarks, the interest rates got repriced in line with the external benchmark rates which supported in increase in NIM. Bank's operational expenses/ average total assets stood stable at 2.08% during FY23 (FY22: 2.06%). PPOP witnessed increase of 35.14% to ₹2,208 crore in FY23 (FY22: ₹1,634 crore) supported by increase in the net interest income. Furthermore, KBL reported lower credit cost of 0.81% during FY23 as against 1.07% during FY22 on account of improvement in GNPA levels leading to Bank's improvement in return on total assets (ROTA) to 1.25% during FY23 as against 0.58% during FY22. Going forward, the bank expects to maintain NIM with focus on increasing exposure to the higher yielding mid corporate/retail/ Agri loans. Furthermore, an increase in NIM will also depend on the ability of the bank to raise deposits at competitive rates and releasing excess liquidity from its investment portfolio.
However, CARE Ratings notes that given the relatively high share of standard restructured assets and SMA portfolio, KBL's ability to limit credit costs at low levels is key to improvement in ROTA.

Stable and granular resource profile with improvement in CASA deposits

The deposit base of the bank has remained stable and sticky and constitutes 88% of total liabilities. The bank has a strong deposit profile with 93% of deposits being in less than ₹2 crore category as on March 31, 2023. The reliance on external borrowings is limited to Tier-II bonds, borrowings from RBI, and other financial institutions. The proportion of low-cost CASA deposits stood at 32.19% as on June 30, 2023 as against 32.97% as on March 31, 2022.
Going ahead, the Bank plans to improve the CASA deposit share which would be crucial for it to raise deposits at competitive rates.

Key weaknesses

Modest asset quality notwithstanding the improvement during FY23

As on March 31, 2023, GNPA and net NPA (NNPA) ratios have improved to 3.74% and 1.70%, respectively, as against 3.90% and 2.42%, respectively, as on March 31, 2022. The bank's slippage ratio continued to remain elevated at 3.31% (PY: 3.11%). However, aided by recoveries and upgradations witnessed in the NPA accounts, overall GNPA levels have witnessed improvement. The bank's provision coverage ratio (PCR) (Excluding Technically Written-Off Accounts), stood at 62.10% as on June 30, 2023 (March 31, 2022: 38.82%).
With reduction in the bank's standard restructured assets from ₹4,115 crore (7.12% of gross advances) as on March 31, 2022 to ₹2,571 crore (4.20% of gross advances) as on March 31, 2023, the gross stressed assets/ gross advances position improved to 8.45% as on March 31, 2023, as against 11.69% as on March 31, 2022. Major portion of restructured accounts will come out of moratorium in Q3FY24 and the repayment behaviour of these borrowers remains to be seen. Also, bank's SMA portfolio stood relatively high at 15.5% of gross advances as on June 30, 2023.
Going forward, reduction in proportion of SMA and restructured portfolio remains critical for the bank to improve the asset quality parameters.

Regional concentration and small size of operations

The bank has limited presence with a small network of 901 branches as on June 30, 2023. With total assets of ₹99,120 crore as on June 30, 2023, KBL is one of the relatively smaller banks in India. The bank's operations are geographically focused in Karnataka which accounted for 575 branches and constituted around 45.8% of the gross advances as on March 31, 2023. The top five states contribute to 82.6% of advances as on March 31, 2023.

Liquidity: Adequate

According to the Bank's structural liquidity statement (SLS) as on March 31, 2023, there are no negative cumulative mismatches in up to 1 year maturity bucket. KBL's liquidity coverage ratio remained comfortable at 328% as on June 30, 2023, against the minimum regulatory requirement of 100%. Furthermore, the Bank has maintained an excess SLR investment of ₹5,942 crore as on June 30, 2023. The excess SLR (as a % of NTDL) stood at 6.63%. These factors provide cushion to the Bank's liquidity profile. Additionally, the Bank has access to systemic liquidity by way of RBI's LAF and MSF schemes.

Environment, social, and governance (ESG) risks

KBL is committed to the well-being of our society and the environment, ensuring that the practices contribute to a greener, more sustainable future. Bank has adopted various policies that imbibe the best practices with regard to environmental, social and governance (ESG) principles. Bank has a well-articulated Board approved ESG policy. ESG Committee of Executives oversees implementation of Bank's Business Responsibility Policy.

Applicable criteria

Criteria for Rating Basel III - Hybrid Capital Instruments issued by Banks
Policy on Default Recognition
Financial ratios – Financial sector
CARE Ratings' criteria for rating of banks
Criteria on Assigning 'Outlook' or 'Rating Watch' to Credit Ratings
CARE Ratings' Policy on Withdrawal of Ratings

About the company and industry

Industry classification

Macro Economic Indicator	Sector	Industry	Basic Industry
Financial Services	Financial Services	Banks	Private Sector Banks

KBL is a Mangalore-based, small-sized, old private sector bank which was set up in 1924. As of June 30, 2023, the branch network was spread across 901 branches and 1,474 ATMs & Recyclers across India. The bank has strong presence in south India with 743 branches as on June 30, 2023 (of which 575 branches are in Karnataka). All the branches are under Core Banking Solution since 2007.

Brief Financials (₹ crore)	March 31, 2022 (A)	March 31, 2023 (A)	June 30, 2023 (UA)
Total operating income	7,176	8,213	2,283
PAT	509	1,180	371
Total assets	90,756	98,110	99,120
Net NPA (%)	2.42	1.70	1.43
ROTA (%)	0.58	1.25	1.50

A: Audited UA: Unaudited; Note: 'the above results are latest financial results available'

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

Rating history for last three years: Please refer Annexure-2

Covenants of rated instrument / facility: Detailed explanation of covenants of the rated instruments/facilities is given in Annexure-3

Complexity level of various instruments rated: Annexure-4

Lender details: Annexure-5

Annexure-1: Details of instruments/facilities

Name of the Instrument	ISIN			Maturity Date		

		Date of Issuance	Coupon Rate		Size of the Issue (₹ crore)	Rating Assigned along with Rating Outlook
Bonds-Lower Tier-II	INE614B08021*	Nov 17, 2012	11.00%	Nov 17, 2022	-	Withdrawn
Bonds-Tier-II Bonds	INE614B08039	Nov 16,2018,	12.00%	Nov 16, 2028	400	CARE A; Stable
Bonds-Tier-II Bonds	INE614B08047	Feb 18, 2019	12.00%	Feb 18, 2029	320	CARE A; Stable
Bonds-Tier-II Bonds	INE614B08054	Mar 30, 2022	10.70%	Mar 30, 2032	300	CARE A; Stable

*Bond has been repaid and redeemed on their respective due date by the bank.

Annexure-2: Rating history for the last three years

		Current Ratings			Rating History			
Sr. No.	**Name of the Instrument/Bank Facilities**	**Type***	**Amount Outstanding (₹ crore)**	**Rating**	**Date(s) and Rating(s) assigned in 2023-2024**	**Date(s) and Rating(s) assigned in 2022-2023**	**Date(s) and Rating(s) assigned in 2021-2022**	**Date(s) and Rating(s) assigned in 2020-2021**
1	Bonds-Lower Tier II	LT	-	-	-	1)CARE A; Stable (24-Aug-22)	1)CARE A; Stable (25-Aug-21)	1)CARE A; Stable (27-Aug-20)
2	Bonds-Tier II Bonds	LT	720.00	CARE A; Stable	-	1)CARE A; Stable (24-Aug-22)	1)CARE A; Stable (25-Aug-21)	1)CARE A; Stable (27-Aug-20)
3	Bonds-Tier II Bonds	LT	300.00	CARE A; Stable	-	1)CARE A; Stable (24-Aug-22)	1)CARE A; Stable (25-Mar-22)	-

*Long term/Short term.

Annexure-3: Detailed explanation of covenants of the rated instruments/facilities: Not Applicable

Annexure-4: Complexity level of the various instruments rated

Sr. No.	Name of the Instrument	Complexity Level
1	Bonds-Lower Tier-II	Complex
2	Bonds-Tier-II Bonds	Complex

Annexure-5: Lender details: Not Applicable

Note on the complexity levels of the rated instruments: CARE Ratings has classified instruments rated by it on the basis of complexity. Investors/market intermediaries/regulators or others are welcome to write to care@careedge.in for any clarifications.

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About us:
Established in 1993, CARE Ratings is one of the leading credit rating agencies in India. Registered under the Securities and Exchange Board of India, it has been acknowledged as an External Credit Assessment Institution by the RBI. With an equitable position in the Indian capital market, CARE Ratings provides a wide array of credit rating services that help corporates raise capital and enable investors to make informed decisions. With an established track record of rating companies over almost three decades, CARE Ratings follows a robust and transparent rating process that leverages its domain and analytical expertise, backed by the methodologies congruent with the international best practices. CARE Ratings has played a pivotal role in developing bank debt and capital market instruments, including commercial papers, corporate bonds and debentures, and structured credit.

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