Karnataka Bank Limited

August 27, 2020

Ratings

Facilities	Amount (Rs. crore)	Rating[1]	Rating Action
Basel III Compliant Tier II Bonds #	**720**	CARE A; Stable (Single A; Outlook: Stable)	Reaffirmed
Lower Tier II Bonds	**250**	CARE A; Stable (Single A; Outlook: Stable)	Reaffirmed

Details of instruments/facilities in Annexure-1

#Tier II Bonds under Basel III are characterized 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 the 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's opinion, the parameters considered to assess whether a bank will reach the PONV are similar to the parameters considered to assess rating of Tier II instruments even under Basel II. CARE has rated the Tier II bonds under Basel III after factoring in the additional feature of PONV.

Detailed Rationale & Key Rating Drivers

The rating assigned to the Bonds issue of Karnataka Bank Limited (KBL) continues to reflect the long and established track record of the Bank with over 90 years in financial services and its sticky retail deposit base. KBL continues to maintain satisfactory capital adequacy position. The Total Capital Adequacy Ratio and Tier I CAR of the bank though slightly moderated to 12.66% and 10.66% respectively as on March 31, 2020 (March 31, 2019: 13.17% and 11.17% respectively), remained well above regulatory requirements. The same improved to 13.07% and 11.07% respectively as on June 30, 2020. However, the capital cushion available with the Bank is lower than that of the industry average as on March 31, 2020. Though the bank may not require any growth capital requirement in the near term on back of expected muted growth in the current fiscal but in case of higher slippages or sizeable portfolio undergoing restructuring, it may be required to raise additional capital. The Bank had earlier taken the Board's approval (in January 2020) to raise equity via QIP but the decline in Bank's share price in recent months poses challenges in fund raising.

Apart from adequate capital cushion, the rating also draws strength from stable profitability though moderated in FY20 due to high operational expenses and provisions requirement. Pre Provisioning operating profit (PPOP) of the Bank improved during FY20 over FY19 but due to higher provisions on account of higher slippages and in bid to improve Provision coverage ratio (PCR), ROTA declined in FY20 over FY19. Net profit of KBL improved to an all-time high quarterly profit in Q1FY21 despite higher requirement for provisions, owing to higher treasury income and it being able to maintain low cost to income at 35.77% in Q1FY21 (Q1FY20: 50.32%). In the wake of COVID, the Bank has made entire 10% provisioning of Rs. 97.40 cr in Q4FY20 and Q1FY21 arising out of regulatory forbearance on asset classification. As on June 30, 2020, around 51.15% of company's outstanding advances were under moratorium. Repayment behavior of moratorium book post completion of moratorium period on August 31, 2020 will be key to KBL's credit profile.

CARE also takes note of Bank's efforts to granulize it advances by reducing its large corporate exposure. On the resource profile front, the Bank's share of retail deposit has been largely sticky and stable. Wholesale deposit of the Bank was less than 1% of total deposit base as on June 30, 2020.

Further, the Bank's liquidity position is adequate with excess SLR at 4.77% as on June 30,2020 and with no negative cumulative mismatches in up to 1 year maturity bucket according to the bank's structural liquidity statement (SLS) as on June 30, 2020 (after considering moratorium effect).

On the contrary, the rating gets constrained due to continuing moderate asset quality parameters. The GNPA % and NNPA% slightly moderated in FY20 mainly due to fresh slippages from the Bank's large corporates exposures in NBFC and export sector. Bank's NNPA/Networth also remained elevated as on March 31, 2020. The Bank does not expect any stress from large accounts but performance of retail assets remains to be seen in the wake of COVID. The rating also gets tempered by the Bank's relatively small size and regional concentration with top 5 states contributing to 80.42% of total credit exposure as on Mar 31, 2020 (PY: 80.15%).

<u>Rating Sensitivities</u>

Positive factors-Factors that could lead to positive rating action/upgrade

- Improvement in CAR > 14% and CETI Ratio of 12 % on a sustained basis
- NNPA/Networth < 20% on sustained basis

[1]*Complete definition of the ratings assigned are available at www.careratings.com and other CARE publications*

Negative factors- Factors that could lead to negative rating action/downgrade

- Material Deterioration in asset quality impacting earnings profile of the bank and inability to maintain sufficient cushion over the regulatory capital.

Detailed description of the key rating drivers

Key Rating Strengths

Long standing track record

KBL is an old generation private sector bank. Established in the year 1924, it has a proven track record of over 90 years 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. Mr. Mahabaleshwara MS is the MD and CEO, who has more than 3 decades of industry experience in banking. He is assisted by a team of General Managers heading various departments. KBL has national presence with a network of 858 branches, 1,024 ATMs spread across 22 states and 2 Union Territories and has employee base of over 8,220 employees. It is currently serving around 11 million customers.

Satisfactory capital adequacy levels

The Total Capital Adequacy Ratio and Tier I CAR of the bank under Basel III stood at 12.66% and 10.66% respectively as on March 31, 2020 (March 31, 2019: 13.17% and 11.17% respectively). The moderation in FY20 CAR is due to growth in Gross Advances from Rs. 56,445 cr in FY19 to Rs. 58,043 cr in FY20. The Total Capital Adequacy % and Tier 1 CAR% of the bank improved to 13.07% and 11.07% respectively as on June 30, 2020.

The Bank has taken a strategic decision to reduce low yielding corporate exposures and increase exposure to high yielding mid corporate/retail/ Agri loans. This led to the Bank's RWA/Advances to increase to 94.65% as on June 30, 2020 as against 90.81% as on March 31, 2020. Though the exposure to relatively riskier segment may increase, but historically, the Bank's GNPA in retail segment has remained at ~4%.

Capital adequacy of KBL is among the lowest among its peers though has been well above the regulatory requirement. Bank had earlier obtained Board approval (on January 27, 2020) to raise Rs. 1500 crore via QIP but due to decline in Bank's share price in recent months, its ability to raise funds would be monitored. Due to expected muted advances growth, Bank's current capital cushion would be adequate to meet growth requirement, but in case of higher slippages or restructuring, it may be required to raise additional capital.

Slight decline in profitability in FY20 though improved in Q1FY21

The Bank reported an increase in total income by 13.94% to Rs.7,871 cr for FY20 from Rs.6,908 cr for FY19. This increase in total income was supported by enhancement in non-interest income by 39.33% and interest income by 9.63%. The advances grew by a modest 3.9% while yield on advances largely remained stable at 9.22% for FY20 (PY: 9.20%). The NII of the Bank registered a moderate growth of 6.58% in FY20 as the interest expenses increased by 11.08% as the Bank had mobilised high cost deposit which led to surge in the cost of deposit to 6.0% (PY: 5.82%) in FY20 (Deposits constitute major source of funding). The Bank's operational expenses increased by 21.46% due to increase in salaries following wage revision by IBA. KBL's cost to income (CTI) also witnessed marginal increase during FY20 and stood at 51.65% as against 50.13% as on March 31, 2019. Even though PPOP improved to Rs. 1,657 cr in FY20 from Rs. 1450 crore in FY19, KBL reported a lower PAT of Rs.432 cr in FY20 as against Rs. 477 crore in FY19. This was due to high provisions of Rs. 1017 cr (PY: Rs. 811 cr) made for NPA in FY20 due to stress in NBFC portfolio and in export sector exposures which led decline in ROTA to 0.54% in FY20 (PY: 0.64%). During Q1FY21, the total income stood at Rs. 2135 cr (PY: Rs. 1829 cr) majorly supported by robust growth in treasury income. The bank's CTI significantly improved to 35.77% in Q1FY21 (Q1FY20- 50.32%) due to high treasury income booked and various cost reduction measures adopted but the same may not be sustainable. PAT improved to an all-time high quarterly in Q1FY21 to Rs. 196 cr (Q1FY20: Rs. 175 cr) due to high non-interest income.

Stable and granular resource Profile

The deposit base of the bank has remained stable and fairly sticky. Bank's deposits have increased by 4.87% to Rs. 71,785 cr as on March 31, 2020 as against Rs. 68,452 crore as on March 31, 2019. The deposit base has been in the same range at Rs. 71,854 as on Jun 30, 2020.

The share of wholesale deposits continued to remain low at 0.08% in FY20 (PY: 1.63%). The share of retail deposits was 71.02% as on Mar 31, 2020 (PY: 70.3%) and was 71.31% as on June 30, 2020. The proportion of low cost CASA deposits largely remained stable at 28.91% as on March 31, 2020 (28.07% as on March 31, 2019) and at 28.66% as on June 30, 2020. The bank has a strong deposit profile with 89.64% (PY: 89.16%) of deposits being in less than 1 crore category as on Mar 31, 2020. Also, the share of top 20 depositors reduced to 2.89% as on Mar'20 from 4.09% as on Mar'19.

Key Rating Weaknesses

Modest asset quality parameters:

As on March 31, 2020, the Gross NPA (GNPA) and Net NPA (NNPA) ratios increased to 4.83% and 3.08% as against 4.41% and 2.95% respectively from the same period last year. The bank's slippage ratio increased to 3.59% (PY: 3.06%). There were fresh slippages of Rs.1,999 cr in FY20 as against Rs.1,448 cr in FY19 mainly due to stress in the NBFC portfolio and in export sector. The bank had provided Rs.1298 cr for NPA in FY20 (PY: Rs. 764 cr). PCR (including TWO) improved from 58.45% as on March 31, 2019 to 64.70% as on March 31, 2020. As of June 30, 2020, the GNPA% and NNPA% slightly improved to 4.64% and 3.01% from Mar'20 levels. KBL has made provisions of Rs. 509 cr (PY: Rs. 201 cr) during Q1FY21 and PCR including TWO stood at 67.93% as on June 30, 2020. (PY: 58.08%).

The Bank's Standard restructured assets stood at Rs. 414 crore (0.73% of net advances) as on March 31, 2020 as against Rs. 299 crore (0.54% of net advances) as on March 31, 2019. Stressed assets as a % of net worth moderated to 50.42% as of Mar'20 from 45.89% as on Mar'19. KBL's security receipts outstanding as on March 31, 2020 were Rs. 382 cr (PY: Rs. 429 cr) which accounted for 0.68% (PY: 0.78 %) of net advances as on that date.

The bank has exposure of Rs. 1413 cr under NCLT referred accounts and has made provisions of Rs.1313 cr which translates to provision cover of almost 93%.

<u>Moratorium Status</u>

The Bank had made entire 10% provisioning of Rs. 97.40 cr in Q4FY20 and Q1FY21. It includes provisions of Rs. 24 cr (Q4FY20) and Rs. 73.40 cr (Q1FY21) provided on Rs. 240 cr (Q4FY20) and Rs. 730 cr (Q1FY21) of standard but overdue advances where asset classification benefit is extended. As on June 30, 2020, 51.15% of the portfolio is under moratorium. The Bank classifies an account as under moratorium even if the client has not paid even a single installment.

It is critical for the bank to maintain a tight control over fresh slippages over the near to medium term considering that more than 51% of the portfolio is under moratorium. Nevertheless, high level of secured nature of the portfolio and increasing share of retail advances may help the Bank maintain asset quality.

Regional concentration and small size of operations

The operations of the bank are mainly spread in the state of Karnataka and in its adjoining states. Karnataka constituted around 41.17% of the total credit exposure as on March 31, 2020 (PY: 43.45%). As on Jun 30, 2020, exposure to Karnataka stood at 42.90% of the total credit exposure. The second highest exposure is to Maharashtra standing at 17.55% as on Mar 31, 2020 (PY: 17.62%) and as June 30, 2020 was 17.46%. The top 5 states contribute to 80.42% of total credit exposure as on Mar 31, 2020 (PY: 80.15%) and as on June 30, 2020 was 79.25%. With total assets of Rs. 82,403 crore as on March 31, 2020; KBL is one of the small sized banks in India.

The bank has limited presence with a small network of 858 branches as on June 30, 2020 and the bank's operations are geographically focused in Karnataka which accounted for 530+ branches. CARE believes that KBL will continue to operate as a small-sized bank with medium regional concentration over the medium term.

Industry Outlook:

The banking sector has been under asset quality pressure over the last four years and more so, now, due to COVID 19. Earlier, the RBI framework for stressed assets led to spike in NPAs in the last quarter of FY18 resulting in increased provisioning and thereby impacting profitability of the banks. The impact of government's recapitalization of public sector banks (PSB) had been largely negated by the incremental provisioning requirement on NPAs leaving PSBs largely dependent on government for growth capital.

Now, there is asset quality pressure on the banks due to the outbreak of COVID-19 and the subsequent extended nation-wide lockdown which had significant impact on the business activity. A recent stress test by RBI on banks indicated that the banks' gross non-performing assets (GNPA) ratio could rise from 8.5 per cent in March 2020 to 12.5 per cent by March 2021.

Banks continue to remain risk averse due to the uncertainty caused by the Covid-19 pandemic and the lockdowns imposed to curb the spread of the virus. Credit growth remains low despite the availability of ample liquidity with banks. Due to moratorium, acquisition of retail assets from NBFCs through direct assignments is very low. Deposit growth continues to run higher than credit growth. Though the lockdown was lifted in some regions during first week of June, the metropolitan region (which accounts for ~63% of bank credit) continues to remain under lockdown coupled with slowdown in economic activities. Additionally, as the Scheduled Commercial Banks are cherry picking their credit portfolios with caution, and with economic activities remaining subdued, the overall bank credit is expected to remain slower in the near term.

<u>Liquidity: Adequate</u>

The Bank's liquidity position is adequate. There were no negative cumulative mismatches in up to 1 year maturity bucket according to the bank's structural liquidity statement (SLS) as on June 30, 2020 (after considering moratorium effect). Further, the bank has maintained excess SLR investment of Rs. 3,524 crore as on June 30, 2020 equivalent to 4.77%. Additionally, the deposit base of the bank remained stable and fairly sticky. KBL's liquidity coverage ratio remained comfortable at 232.62% as on June 30, 2020 against the minimum regulatory requirement of 100%. Additionally, the bank has access to systemic liquidity by way of RBI's LAF and MSF schemes.

Analytical approach*:* Standalone
Applicable Criteria
[CARE's Criteria on assigning Outlook to Credit Ratings]
[CARE's Policy on Default Recognition]
[Financial ratios – Financial sector]
[CARE's Rating Methodology for Banks]
[CARE's rating approach for BASEL III]

About the Company
Karnataka Bank Ltd. (KBL) is a Mangaluru-based, small-sized, old private sector bank which was set up in 1924. As on June 30, 2020, the branch network was spread across 858 branches and 1,024 ATMs across India. The Bank has strong presence in South India with 671 branches as on June 30, 2020 (of which 533 branches are located in Karnataka). All the branches are under Core Banking Solution since 2007. The day-to-day affairs of the bank are looked after by Mr. Mahabaleshwara M S (Managing Director and CEO). He is assisted by a team of General Managers heading important functions of credit, recovery, treasury, risk management, planning and development, information technology, vigilance, etc.

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

Brief Financials (Rs. crore)	FY19 (A)	FY20 (A)
Total operating income	6908	7,871
PAT	477	432
Interest coverage (times)	1.36	1.37
Total Assets	78,269	82,403
Net NPA (%)	2.95	3.08
ROTA (%)	0.64	0.54

A: Audited

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

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

Annexure-1: Details of Instruments/Facilities

Name of the Instrument	ISIN	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Bonds-Lower Tier II	INE614B08021	November 17, 2012	11.0%	November 17, 2022	250.00	CARE A; Stable
Bonds-Tier II Bonds	INE614B08039, INE614B08047	November 16, 2018, February 18, 2019	12.0%	November 16, 2028, February 18, 2029	400.00 320.00	CARE A; Stable

Annexure-2: Rating History of last three years

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating history			
		Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019	Date(s) & Rating(s) assigned in 2017-2018
1.	Bonds-Lower Tier II	LT	-	-	-	-	1)Withdrawn (17-Oct-18) 2)CARE A; Stable (26-Sep-18)	1)CARE A; Stable (09-Oct-17)
2.	Bonds-Lower Tier II	LT	-	-	-	-	1)Withdrawn (29-May-18)	1)CARE A; Stable (09-Oct-17)
3.	Bonds-Lower Tier II	LT	250.00	CARE A; Stable	-	1)CARE A; Stable (30-Aug-19)	1)CARE A; Stable (26-Sep-18)	1)CARE A; Stable (09-Oct-17)
4.	Bonds-Tier II Bonds	LT	720.00	CARE A; Stable	-	1)CARE A; Stable (30-Aug-19)	1)CARE A; Stable (26-Sep-18)	-

Annexure-3: Detailed explanation of covenants of the rated instrument / facilities:

Name of the Instrument	Detailed explanation
A. Non-Financial covenants	
Lower Tier II Bonds	Optional call date: After 18.11.2017 Subsequent call Dates: On every anniversary of coupon payment date after first call option due date.
Basel III Compliant Tier II bonds	Optional call date: After 16.11.2023, Rs.400 cr After 18.02.2024, Rs.320 cr Subsequent call Dates: On every anniversary of coupon payment date after first call option due date.

Annexure 4: Complexity level of various instruments rated for this Bank

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

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

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About CARE Ratings:
CARE Ratings commenced operations in April 1993 and over two decades, it has established itself as one of the leading credit rating agencies in India. CARE is registered with the Securities and Exchange Board of India (SEBI) and also recognized as an External Credit Assessment Institution (ECAI) by the Reserve Bank of India (RBI). CARE Ratings is proud of its rightful place in the Indian capital market built around investor confidence. CARE Ratings provides the entire spectrum of credit rating that helps the corporates to raise capital for their various requirements and assists the investors to form an informed investment decision based on the credit risk and their own risk-return expectations. Our rating and grading service offerings leverage our domain and analytical expertise backed by the methodologies congruent with the international best practices.

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