February 02, 2024

Karnataka Bank Limited: Ratings reaffirmed; outlook revised to Positive from Stable

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Tier II Bonds	620.00	620.00	[ICRA]A (Positive); reaffirmed and outlook revised to Positive from Stable
Basel III Tier II Bonds	400.00	0.00	[ICRA]A (Positive); reaffirmed and withdrawn; outlook revised to Positive from Stable
Certificates of Deposit	1,500.00	1,500.00	[ICRA]A1+; reaffirmed
Total	**2,520.00**	**2,120.00**	

**Instrument details are provided in Annexure I*

Rationale

The revision in the outlook on the long-term rating factors in the sustained improvement in Karnataka Bank Limited's (KBL) earnings profile, driven by the higher credit growth, which was also supported by the equity capital raise. The ratings 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, as well as the adequate capitalisation profile with Tier I capital of 13.66%[1] as on December 31, 2023. While KBL had raised equity capital in Q2 FY2024, which has added to its existing capital cushions, however the impact of transitioning to provisioning, based on the expected credit loss (ECL) framework, on the capital and profitability levels will remain a monitorable.

The bank's headline asset quality metrics remained steady. However, the share of vulnerable loans {overdue loan accounts, i.e. SMA[2] accounts (SMA-1 and SMA-2), standard restructured advances and net non-performing advances (NNPAs)}, which formed ~8% of the standard advances as of September 30, 2023, continued to be sizeable and will remain a monitorable from the asset quality standpoint. Nonetheless, the potential vulnerable book went through a sustained reduction from the comparatively higher levels in the last 1-2 years. The ability to sustain this reduction will be key for keeping the profitability on an improving trajectory and maintaining the capital cushions 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 Positive outlook on the long-term rating reflects ICRA's expectation 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. 400-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] Excluding profit for 9M FY2024

[2] 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 around 100 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. 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 3.55% as on March 31, 2023 (3.44% as on March 31, 2022).

Notwithstanding the above, the relatively lower share of current account savings account (CASA) deposits in the overall deposit base (CASA share of 39% in H1 FY2024 for the banking sector) results in a comparatively higher cost of interest-bearing funds. The bank's cost of average interest-bearing funds remained higher at 5.11% in 6M FY2024 (4.70% in FY2023) against the banking sector average of 4.93% for 6M FY2024(annualised). However, KBL's CASA ratio of 31.45%, as on December 31, 2023, is comparable with similarly-sized peers.

Adequate capitalisation levels – KBL's capitalisation profile remains adequate with a CET I/Tier I capital ratio of 13.66%[1] as on December 31, 2023 (12.20%[3] as on December 31, 2022), which remains adequate compared to the regulatory requirement of 9.5%. The capitalisation levels were supported in 9M FY2024 by the equity capital raise of Rs. 800 crore. The bank has stated its plan to raise further equity capital of Rs. 700 crore in the near term, which would add to its capital cushions, supporting its growth plans for the medium term. Going forward, the ability to sustain the improvement in the asset quality and maintain the profitability levels will be key for generating growth capital.

Notwithstanding the improvement in the capitalisation profile, the Reserve Bank of India (RBI) issued a discussion paper for transitioning to the expected loss framework for credit exposures. Banks with a high share of overdue/restructured loans could see a one-time impact on their capital position upon transitioning. While the RBI has proposed that these provisions should be spread over a five-year period for the computation of the regulatory capital ratios, the impact on the capital position (without taking regulatory forbearance) will remain a monitorable.

Profitability improves– Historically, KBL's net interest margin (NIM) remained below the private sector banks' (PVBs) average, mainly due to the relatively higher cost of funds and weak credit growth, resulting in the bank carrying excess liquidity. 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 (2.03% of average total assets (ATA) for KBL vs 2.78% for PVBs in H1 FY2024). The decline in the credit costs to 0.5% of ATA (annualised) in 9M FY2024 from 0.7-1.6% in FY2018-FY2023 also supported the profitability. However, considering the sizeable vulnerable 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 annualised return on assets (RoA) and return on equity (RoE), which increased to 1.32% and 15.90%, respectively, in 9M FY2024 from 1.24% and 14.37%, respectively, in FY2023.

Credit challenges

Stressed assets remain elevated despite reduction – KBL's fresh NPA generation rate[4] moderated to 2.54% (annualised) in 9M FY2024 (3.31% in FY2023), but remained above the banking sector average. With recoveries and upgrades and the increase in the loan book, the headline gross NPA (GNPA) and net NPA (NNPA) ratios improved marginally to 3.64% and 1.55%, respectively, as on December 31, 2023, from 3.74% and 1.70%, respectively, as on March 31, 2023. Notwithstanding this, KBL's overdue book, i.e. SMA-1 and SMA-2 accounts, stood at 3.43% of the standard advances as on September 30, 2023, increasing moderately from 2.99% as on December 31, 2022, while the standard restructured book declined to Rs. 1,837 crore (2.74% of standard advances) as on December 31, 2023 from Rs. 3,058 crore (4.97% of standard advances) as on December 31, 2022, though it remains elevated. Accordingly, the overall potential vulnerable loans (SMA-1, SMA-2 and the standard restructured book, net of overlap) remained high at 58% of the core capital as on December 31, 2023 despite moderating from 70% as on

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[3] Excluding 9M FY2023 profit
[4] Fresh NPA generation – Gross fresh slippages/opening standard advances

December 31, 2022. KBL's ability to minimise slippages from the potential vulnerable book, which also remains high compared to peer banks, will be key for ensuring continued improvement in the profitability levels and maintaining solvency[5] at comfortable levels.

High geographical concentration – KBL's operations are highly concentrated in southern India, which accounted for ~63% of the total exposure (fund based and non-fund based) as on March 31, 2023 (62% as on March 31, 2022). The branches remain concentrated with South India and Karnataka accounting for ~80% and ~64%, respectively, of the total branches as on December 31, 2023. Further, some of the bank's exposures are large in relation to its core capital. The top 20 exposures accounted for 124% of the core capital as on March 31, 2023. Despite moderating from 129% as on March 31, 2022, the same was high compared to 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, the same 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 material lapses could be detrimental to their reputation and invite regulatory censure. KBL has not faced any material lapse 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 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 6.7% of net demand and time liabilities (NDTL) as on November 11, 2023, over and above the regulatory ask of 18%, resulting in positive cumulative mismatches in the maturity bucket of up to one year. Additionally, the low level of non-operational deposits in total deposits continued to keep the liquidity coverage ratio (LCR) at a comfortable level of 266% in Q3 FY2024. Further, the net stable funding ratio (NSFR) stood at 136% against the regulatory ask of 100% as on December 31, 2023.

KBL's ability to maintain a strong liquidity profile will continue to be driven by the high rollover of term deposits. Moreover, 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 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, maintaining the profitability and solvency ratios with an RoA of more than 1.0%, while ensuring that net stressed assets/core equity remains below 25% and the Tier I capital cushions remain above 2% on a sustained basis, would lead to a rating upgrade.

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[5] *Solvency profile = Net stressed assets / Core capital; net stressed assets include NNPAs, net non-performing investments (NPIs) and net security receipts (SRs)*

Negative factors – The rating outlook could be revised to Stable 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 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 capital/funding requirement of KBL's subsidiary (KBL Services Limited), going forward, has been factored in.

About the company

KBL is a mid-sized private bank with a market share of 0.4% in advances in the Indian banking sector, as on September 30, 2023, and is nearly 100 years old as it was set up in 1924 in Mangalore. With an asset size of Rs. 1.10 lakh crore as on December 31, 2023, KBL is widely held by public individuals (57.2%), foreign institutional investors and foreign portfolio investors (19.0%), domestic institutions (17.7%) and corporate bodies and others (6.1%). It had a network of 904 branches and 1,482 ATM outlets as on December 31, 2023 with ~80% of its total branches located in South India.

Key financial indicators (standalone)

Karnataka Bank Limited	FY2022	FY2023	9M FY2023	9M FY2024
Total income	7,176	8,213	6,048	6,997
Profit after tax	509	1,180	826	1,032
Total assets (Rs. lakh crore)	0.92	0.99	1.00	1.10
CET I	12.65%	14.18%	12.20%*	13.66%*
CRAR	15.66%	17.45%	15.13%*	15.88%*
PAT / ATA	0.58%	1.24%	1.15%	1.32%
Gross NPAs	3.90%	3.74%	3.28%	3.64%
Net NPAs	2.42%	1.70%	1.66%	1.55%

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

Total income = Net interest income + Non-interest income

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

		Current rating (FY2024)			Chronology of rating history for the past 3 years				
		Type	Amount rated	Amount outstanding	Date & rating in FY2024	Date & rating in FY2023	Date & rating in FY2022		Date & rating in FY2021
			(Rs. crore)	(Rs. crore)	Feb-02-2024	Mar-16-2023	Mar-25-2022	Sep-27-2021	Oct-15-2020
1	**Basel III Tier II Bonds**	Long term	620.00	620.00	**[ICRA]A (Positive)**	**[ICRA]A (Stable)**	**[ICRA]A (Stable)**	**[ICRA]A (Stable)**	**[ICRA]A (hyb) (Stable)**
2	**Basel III Tier II Bonds**	Long term	400.00	-	**[ICRA]A (Positive); Withdrawn**	**[ICRA]A (Stable)**	**[ICRA]A (Stable)**	**[ICRA]A (Stable)**	**[ICRA]A (Stable)**
3	**Certificates of Deposit**	Short term	1,500.00	-^	**[ICRA]A1+**	**[ICRA]A1+**	**[ICRA]A1+**	**[ICRA]A1+**	**[ICRA]A1+**

^ *Amount yet to be placed*

In compliance with the circular issued by the Securities and Exchange Board of India (SEBI) on July 16, 2021, for standardising the rating scales used by credit rating agencies, ICRA has discontinued its practice of affixing the (hyb) suffix alongside the rating symbols for hybrid instruments.

Accordingly, ICRA has removed the (hyb) suffix that was earlier being placed alongside the rating symbol for the hybrid instruments issued by KBL. The earlier and revised denotation of the rating for various instruments can be seen in the table above. This rating action only involves the removal of the (hyb) suffix and should not be construed as a change in the credit rating.

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
INE614B08039	**Basel III Tier II Bonds**	Nov-16-2018	12.00%	Nov-16-2028*	400	[ICRA]A (Positive); withdrawn
INE614B08047	**Basel III Tier II Bonds**	Feb-18-2019	12.00%	Feb-18-2029^	320	[ICRA]A (Positive)
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 25, 2024

**Call option exercised; ^ Call option due on February 18, 2024; # Call option due on March 30, 2027*

The subsequent call dates for the above two 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 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

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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.

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