

DISCLOSURE UNDER PILLAR III OF BASEL III ACCORD

1. SCOPE OF APPLICATION

The Karnataka Bank Limited, a premier private sector Bank, was incorporated on February 18th 1924 in Mangalore. The Bank does not have any subsidiary/Associate companies under its Management.

The Bank presently is not involved in insurance business. However, Bank has entered in to a Joint venture agreement and holds equity investments to the extent of 15 per cent in M/s Universal Sompo General Insurance Company Limited. The financials of the joint venture company are not consolidated with the balance sheet of the Bank. The investment in the joint venture is not deducted from the capital funds of the Bank but is assigned risk weights as an investment.

2. CAPITAL STRUCTURE

(Rs in crore)

	Particulars	No of equity Shares	Face value per share	Amount
1	Authorized Capital	300000000	10	300.00
2	Issued Capital	188461602	10	188.46
3	Subscribed Capital	188455524	10	188.45
4	Called up/Paid up Capital	188438974	10	*188.45

*inclusive of forfeited shares

The Bank's shares are listed on the National Stock exchange of India Ltd and Bombay Stock Exchange Ltd.

During the half year ended September 30, 2014 the Bank has allotted 26602 equity shares under equity shares to employees under its Employee Stock Option Plan and release of entitlements kept in abeyance during earlier right issue. Apart from the above, Bank has not raised any capital by IPO, Rights or by Public offer during the half year ended September 30, 2014.

Breakup of Capital Funds

The Tier I Capital of the Bank comprises of

(Rs in crore)

1	Paid up Capital (Including forfeited shares)	188.45
2	Reserves	2863.87
	Total	3052.32

The Tier II Capital of the Bank comprises of

		(Rs in crore)
1	Undisclosed reserves	15.95
2	General Provisions and Loss Reserves	217.88
3	Subordinated debts eligible for inclusion in Lower Tier 2 Capital	385.90
	Total	619.73

The Total capital comprises of

		(Rs in crore)
1	Tier I Capital	3052.32
2	Tier II Capital	619.73
	Total	3672.05

Details of the aggregate amounts of the bank's total interests in insurance entities, which are risk-weighted :

(Rs. in crores)				
Name of the insurance entities / country of incorporation	Principle activity of the entity	Total balance sheet equity (as stated in the accounting balance sheet of the legal entity)	% of bank's holding in the total equity / proportion of voting power	Quantitative impact on regulatory capital of using risk weighting method versus using the full deduction method
Universal Sompo General insurance Co Ltd / India	General Insurance	350	15%	CRAR is reduced by 0.08%

Assessment of Capital Adequacy

An assessment of the capital requirement of the Bank is carried out through comprehensive projections of future business that takes cognizance of the strategic intent of the Bank, profitability of particular business and opportunities for growth. The proper mapping of credit, operational and market risks to this projected business growth enables assignment of capital that not only adequately covers the minimum regulatory capital requirements but also provides headroom for growth. The calibration of risk to business is enabled by a strong risk culture in the Bank aided by effective, technology based risk management systems.

A summary of the Bank's Capital requirement under Basel III for credit, market and operational risk and the capital adequacy ratio is detailed below.

(Rs in crore)

A	Capital requirement for Credit Risk	
	-Portfolios subject to Standardized approach	2398.33
	-Securitization exposures	-
B	Capital requirement for Market Risk	
	Standardized duration approach	130.81
	-Interest rate Risk	92.16
	-Foreign exchange risk	1.35
	-Equity Risk	37.30
C	Capital requirement for Operational Risk	
	-Basic Indicator approach	196.90
D	Total Capital requirement	2726.04
E	Total eligible Capital Funds of the Bank as per Basel III	3659.93
F	Total Risk Weighted Assets	30289.35
G	Common Equity Tier I ratio (CET1) (%)	10.04%
H	Tier I CRAR (%)	10.04%
I	Tier II CRAR (%)	2.04%
J	Total CRAR (%)	12.08%

3. RISK MANAGEMENT: OBJECTIVES AND ORGANIZATION STRUCTURE

The various risks taken by the Bank during the course of the business development are identified, assessed, measured, controlled, monitored, mitigated and reported effectively. The key components of the Bank's risk management rely on the risk governance architecture, comprehensive processes and internal control mechanism. The Bank's risk governance architecture focuses attention on key areas of risk such as credit, market and operational risk and quantification of these risks wherever possible for effective and continuous monitoring.

a. Objectives and Policies

The Bank's risk management processes are guided by well-defined policies appropriate for various risk categories, independent risk oversight and periodic monitoring through the sub-committees of the Board of Directors. The Bank has a well documented Board approved 'Risk Management Policy' in place. The Board sets the overall risk appetite and philosophy for the Bank. The Board of Directors, the Integrated Risk Management Committee and the Audit

Committee of the Board review various aspects of risk arising from the businesses of the Bank.

b. Structure and Organization

The Bank has a risk management system that is centralized with a three track committee approach. The committees are- Credit Policy Committee (CPC), Asset Liability Management Committee (ALCO) and Operational Risk Management Committee (ORMC). An Integrated Risk Management Committee (IRMC) evaluates the overall risk factors faced by the bank and directly reports to the Board of directors.

CPC deals with credit policies and procedures, ALCO deals with Asset Liability Management (ALM) and Investment Policy of the Bank and ORMC formulates policies and procedures for managing operational risk.

4. CREDIT RISK MANAGEMENT

Bank has developed online comprehensive credit risk rating system for all borrower accounts. Risk rating of borrowers intended to help banks in quantifying and aggregating the credit risk across various exposures. The bank has validated its existing rating models and refined/revised the corporate models, besides introduction of Specialized lending rating models, Retail score card models [Pool based approach] and Facility rating. Accordingly, bank is rating its credit portfolio as per the criteria laid down for rating in the Loan Policy of the Bank. The rating serves as a single point indicator of diverse risk factors of counter-party and for taking credit decisions. The risk rating system is drawn up in a structured manner, incorporating different factors such as borrower and industry specific characteristics. The Bank also undertakes periodic validation exercise of its rating models and also conducts migration and default rate analysis to test robustness of its rating models.

The Bank has formulated a comprehensive Loan Policy by incorporating various parameters and prudential limits to manage and control default, transaction and intrinsic/concentration risk. The credit exposures are taken after subjecting the proposals to analysis of various risk factors such as financial risk, industry risk, management risk, business risk, transaction risk etc.

The Bank analyses the migration of borrowers in various risk rating categories to gauge the quality of the loan portfolio. The Bank also conducts periodical review of the loan assets to ascertain conduct of the accounts. The Bank conducts periodical Credit Audit and Stock Audit of large credit exposures to limit the magnitude of credit risk and interest rate risk.

Credit sanction and related processes

Know Your Customer is a leading principle for all business activities. The other components of the credit processes are:

1. Sound credit approval process with well laid credit sanctioning criteria .
2. The acceptability of credit exposure, primarily based on the sustainability and adequacy of borrower's normal business operations and not based solely on the availability of security.
3. Portfolio level risk analysis and reporting to ensure optimal spread of risk across various rating classes to prevent undue risk concentration across any particular industry segments and monitor credit risk migration.
4. Sector specific studies at periodic intervals to highlight risks and opportunities in those sectors.
5. Adoption of rating linked exposure norms .

6. Industry-wise exposure ceilings based on the industry performance, prospects and the competitiveness of the sector.
7. Separate risk limits for credit portfolios like advances to NBFC and unsecured loans that require special monitoring.

Review and Monitoring

1. All credit exposures, once approved, are monitored and reviewed periodically against the approved limits. Borrowers with lower credit rating are subject to more frequent reviews.
2. Credit monitoring involves independent review of credit risk assessment, compliance with internal policies of the Bank and with the regulatory framework, compliance with the sanction terms and conditions and effectiveness of loan administration.
3. Customers with emerging credit problems are identified early and classified accordingly. Remedial action is initiated promptly to minimize the potential loss to the Bank.

Concentration Risk

The Bank controls concentration risk by means of appropriate sectoral limits and borrowers limits based on creditworthiness. The Bank also captures the Concentration risk by monitoring the geographical exposure.

Large exposures to individual clients or group

The Bank has individual borrower-wise exposure ceilings based on the internal rating of the borrower as well as group-wise borrowing limits. The Bank monitors the level of credit risk (Low/Moderate/High/Very High) and direction of change in credit risk (increasing /decreasing/ stable) at the portfolio level.

Definition of Non-Performing Assets

Bank has adopted the definition of the past due and impaired assets (for accounting purposes) as defined by the regulator for income recognition and asset classification norms.

Exposures

A. Total gross credit exposure including geographic distribution of exposure

(Rs in crore)

	Domestic	Overseas	Total
Fund Based	34616.69	-	34616.69
Non Fund based	5443.72	-	5443.72
Total	40060.41	-	40060.41

Geographic distribution of credit exposure

(Rs in crore)

State Name	Fund Based	Non Fund Based	Total Exposure
Andhra Pradesh	1169.82	124.91	1294.73
Assam	68.57	46.28	114.85
Bihar	8.26	105.00	113.26
Chandigarh	50.70	3.26	53.96
Chhattisgarh	343.53	36.52	380.05
Delhi	3715.21	499.37	4214.58
Goa	167.83	37.82	205.65

Gujarat	324.16	66.12	390.28
Haryana	1010.37	333.10	1343.47
Jharkhand	45.30	2.11	47.41
Karnataka	13637.72	1719.53	15357.25
Kerala	356.99	11.29	368.28
Madhya Pradesh	266.85	17.30	284.15
Maharashtra	5260.16	807.77	6067.92
Orissa	466.56	43.59	510.14
Pondicherry	37.48	1.89	39.37
Punjab	406.28	113.63	519.91
Rajasthan	700.23	56.98	757.21
Tamil Nadu	3205.96	426.55	3632.50
Telangana	1647.98	646.97	2294.95
Uttar Pradesh	566.86	190.39	757.25
Uttarakhand	66.52	2.86	69.37
West Bengal	1093.37	150.49	1243.87
Total Exposure	34616.69	5443.72	40060.41

While determining level and direction of credit risk, parameters like percentage of low- risk credit (investment grade and above) to credit risk exposure and migration from investment to non-investment grade (quantum as percentage of credit risk exposure) are also considered. The Bank monitors the rating-wise distribution of its borrowers also.

Exposure to Industries

Industry analysis plays an important part in assessing the concentration risk within the loan portfolio. Particular attention is given to industry sectors where the Bank believes that there is a high degree of risk or potential for volatility in the future. The Bank has fixed internal limits for aggregate commitments to different sectors so that the exposures are evenly spread over various sectors.

The credit policy deals with short term as well as long term approach to credit risk management. The policy of the Bank embodies in itself the areas of risk identification, risk measurement, risk grading techniques, reporting and risk control systems /mitigation techniques, documentation practice and the system for management of problematic loans.

B. Distribution of Credit Exposure by Industry sector (Rs in Crore)

Sl. No.	Industry	Fund Based	Non Fund Based	Total Exposure
1	Infrastructure advances	2873.77	317.71	3191.48
2	Other Textiles	928.92	146.29	1075.21
3	Other Engineering	676.49	342.79	1019.28
4	Cotton Textile	817.35	137.91	955.26
5	Gems and Jewellery	718.23	42.07	760.3
6	Iron and Steel	661.81	76.17	737.98
7	Automobiles	541.94	46.46	588.4

8	Metal and Metal Products	339.75	133.99	473.74
9	Cement and Cement Products	412.02	23	435.02
10	Rice, Flour, Dhal Mills	407.48	21.15	428.63
11	Wood Based Industries	112.58	236.92	349.5
12	Plastic and Plastic Products	263.66	81.55	345.21
13	Food and Food Products	288.05	12.55	300.6
14	Paper and Paper Products	248.24	33.18	281.42
15	Petroleum Products	257.19	0.71	257.9
16	Drugs and Pharmaceuticals	109.16	60.84	170
17	Coal and Mining	112.12	2.96	115.07
18	Chemicals, Dyes	89.83	15.83	105.66
19	Kandasari and Sugar	102.98	2.1	105.08
20	Tea Industry	74.92	0.29	75.21
21	Computer Software and Computer Hardware	33.04	23.06	56.1
22	Leather and Leather Products	28.11	20.59	48.7
23	Electronics	25.67	4.1	29.77
24	Jute Textile	26.16	2.41	28.57
25	Cashewnut Processing	24.6	0	24.6
26	Rubber and Rubber Products	16.48	6.88	23.37
27	Distilleries, Breweries including soft drinks	22.04	0.34	22.38
28	Vegetable Oil	17.31	0	17.31
29	Tobacco and Tobacco Products	1.64	0	1.64
30	Marine Products/Processing	0.02	0	0.02
31	All Other Industries	781.22	288.76	1069.98
	TOTAL INDUSTRIAL ADVANCE	11012.81	2080.6	13093.41

The details of the Industry wherein the bank's exposure in the related Industry has exceeded the 5 per cent of total gross credit exposure is furnished below.

SI No	Industry / sectors classification	Percentage of the total credit exposure
1	Infrastructure advances	7.97 %

C. Residual Contractual Maturity of Advances and Investments (Rs in crore)

SI No	Maturity Buckets	Advances	Investments
1	1 day	1135.45	557.07
2	2 to 7 days	146.80	208.68
3	8 to 14 days	251.86	124.72
4	15-28 Days	242.54	303.44
5	29 Days to 3 Months	1569.16	1191.73
6	Over 3 Months to 6 Months	1563.18	253.21

7	Over 6 Months to 12 Months	3113.46	781.72
8	Over 1 Year to 3 years	13839.79	2585.51
9	Over 3 Years to 5 Years	3288.61	2784.55
10	Over 5 Years	4566.78	8142.32
	Total	29717.63	16932.95

D. Classification of Non Performing Advances

(Rs in Crore)

		30.09.2014
A	Amount of NPA's (Gross)	1060.88
	-Substandard	441.68
	-Doubtful 1	316.88
	-Doubtful 2	181.69
	-Doubtful 3	22.89
	-Loss	97.74
B	Net NPAs	
	Amount of Net NPA	702.24
C	NPA Ratios	
	Gross NPAs to Gross Advances ratio (%)	3.53
	Net NPAs to Net Advances ratio (%)	2.37

Movement of NPAs (Gross)

(Rs in crores)

	30.09.2014
1. Opening Balance as on 01.04.2014	835.93
2. Additions	495.94
3. Reductions	270.99
4. Closing Balance as on 30.09.2014	1060.88

Movement of Provisions for NPAs

(Rs. in crores)

	30.09.2014
1. Opening Balance	271.53
2. Provision made during the period	129.53
3. Write off	74.17
4. Write back of excess provisions	0.00
5. Closing balance	326.89

E. Non Performing Investments and movement of provision for depreciation on Investments

(Rs in Crore)

		30.09.2014
A	Amount of Non performing Investments	19.49
B	Amount of Provision held for Non performing Investments	19.49
C	Movement of provisions for depreciation on Investments	
	a)Opening balance	97.01
	b) Add: Provisions made during the year	0.00
	c) Less: Write off/write back of excess provisions	26.28
	d) Closing balance	70.73

Disclosure for portfolios subject to the standardized approach

Large corporate borrowers and Public Sector Enterprises are being encouraged to solicit ratings from approved external rating agencies and wherever such ratings are available the Bank uses the same in assigning risk weights. Bank has approved 6 domestic credit rating agencies identified by RBI i.e. CRISIL, CARE, India Ratings and Research Private Limited (earlier FITCH India), ICRA, Brickwork and SMERA Ratings Limited. The ratings available in public domain are mapped according to risk profile and specific risk characteristics of each rating grade of respective agencies as envisaged in RBI guidelines.

The credit exposure [fund based & non fund based] after risk mitigation (subject to the standardized Approach) in different risk buckets are as under:

(Rs in Crore)

SI No	Risk weight	Exposure Outstanding
1	Below 100%	11516.30
2	100%	11085.39
3	More than 100%	4487.18
	Total	27088.87

Credit Risk Mitigation: Disclosures for Standardized Approach

As stipulated by the RBI guidelines, the Bank uses the comprehensive approach for collateral risk mitigation. Under this approach, the Bank reduces its credit exposure to counterparty when calculating its capital requirements to the extent of risk mitigation provided by the eligible financial collateral as specified in the Basel guidelines.

Types of eligible financial collateral / Guarantors:

The Bank recognizes only specified types of financial collateral and guarantees (counter-guarantors) for providing capital relief in line with Basel II guidelines on credit risk mitigation.

This includes cash, Bank own deposits, gold (including bullion and jewellery, subject to

collateralized jewellery being notionally converted/benchmarked to 99.99 per cent purity), securities issued by the Central and State Governments, KisanVikasPatra, National Savings certificates, life insurance policies with a declared surrender value which is regulated by IRDA, certain debt securities rated by a recognized credit rating agency, certain debt securities not rated but issued by Banks and listed on a recognized exchange and are classified as senior debt, certain mutual fund units where daily Net Assets Value (NAV) is available in public domain .

Eligible Guarantors (counter-guarantors):

Credit protection given by the following entities is recognized:

- (i) Sovereigns, sovereign entities (including BIS, IMF, European Central Bank and European Community as well as permitted MDBs, ECGC, CRGFTLIH and CGTMSE), banks and primary dealers with a lower risk weight than the counterparty;
- (ii) Other entities that are externally rated except when credit protection is provided to a securitization exposure. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor.
- (iii) When credit protection is provided to a securitization exposure, other entities that currently are externally rated BBB- or better and that were externally rated A- or better at the time the credit protection was provided. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor.

The extent of total credit exposure (under the standardized approach) covered by eligible financial collaterals after application of haircuts are furnished below:

	(Rs in crore)
Eligible financial collaterals after haircuts	4503.24
Eligible guarantees	719.18

5. MARKET RISK & LIQUIDITY RISK

The Bank has put in place Board approved Integrated Treasury Policy and Asset Liability Management (ALM) policy for effective management of market risk in the Bank. The objective of Integrated Treasury Policy is to assess and minimize risks associated with treasury operations by extensive use of various risk management tools. Broadly, it encompasses Policy prescriptions for managing systemic risk, credit risk, market risk, operational risk and liquidity risk in treasury operations.

For market risk arising out of various products in treasury and its business activities, the Bank has set regulatory / internal limits and ensures the adherence thereof. Migration of ratings is tracked regularly. Limits for exposures to counter-parties, industries and countries are monitored and the risks are controlled through Stop Loss Limits, Overnight limit, Daylight limit, Aggregate Gap limit, Individual gap limit, Value at Risk (VaR) limit for Forex, Inter-Bank dealing and various investment limits. For the Market Risk Management the Bank has a Mid Office. The functions of Mid Office are handled by Integrated Risk Management Department.

The Board, IRMC & ALCO are overseeing the market risk management of the Bank, procedures thereof, implementing risk management guidelines issued by regulator, best risk management practices followed globally and ensures that internal parameters, procedures, practices/policies and risk management prudential limits are adhered to.

The policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigates are discussed in ALCO and based on views taken by / mandates of ALCO, hedge deals are undertaken.

Liquidity risk of the Bank is assessed through daily gap analysis for maturity mismatch based on residual maturity in different time buckets as well as various liquidity ratios and management of the same is done within the prudential limits fixed thereon. Advance techniques such as Stress testing, simulation, sensitivity analysis etc. are conducted on regular intervals to draw the contingency funding plan under different liquidity scenarios.

Market Risk in Trading Book

Bank has adopted the Standardized Duration Approach as prescribed by RBI for computation of capital charge for market risk and is fully compliant with such RBI guidelines. Bank is now preparing itself for the Advanced Approach based on a Value at Risk (VaR) model, which is under implementation.

**The capital requirements for market risk are detailed below:
(Rs in crore)**

Sl No	Risk Category	Capital Charge
I	Interest Rate	92.16
II	Equity	37.30
III	Foreign Exchange , Gold and Derivatives	1.35
IV	Total Capital Charge for market Risk (I+II+III)	130.81

6. INTEREST RATE RISK IN THE BANKING BOOK (IRRBB)

The interest rate risk is viewed from two perspectives i.e. 'Earnings Perspective' and 'Economic Value Perspective'. Generally, the former is measured using Earnings-at-Risk (EaR) under Traditional Gap Analysis (TGA) and the latter is measured through changes in the Market value of Equity (MVE) under Duration Gap Analysis (DGA).

➤ **Earnings-at-Risk (EaR):**

All the Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) maturing/re-pricing up to 1 year are bucketed as per Traditional Gap Analysis (TGA) and EaR analysis is conducted by applying various shocks on product-wise weighted average interest rates in each time band. EaR is quantified by changes in the NII and NIM in comparison with the previous financial year end.

➤ **Impact on Market Value of Equity (MVE):**

Impact on Market Value of Equity (MVE) is analyzed through Duration Gap Analysis (DGA) which involves bucketing of market value of all Rate Sensitive Assets and Rate Sensitive Liabilities as per residual maturity/ re-pricing in various time bands and computing Modified Duration Gap. Accurate method is adopted for computing the

market value by discounting each cash flow of all Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) with various discount curves as suggested by RBI. Notional interest rate shocks are applied on the resultant Modified Duration Gap to arrive at the changes in the Market Value of Equity (MVE).

- Prudential limits have been fixed for changes in NIM and MVE for 200bps shock in the interest rates and monitored on a monthly basis.
- Earning at Risk for 200 bps interest rate shock is estimated at Rs.76.85crore and change in the Market value of Equity for 200 bps interest rate shocks is 4.008%.

8. OPERATIONAL RISK

Strategies and Processes

Bank has initiated several measures to manage operational risk through identification, assessment and monitoring of inherent risks in all its business processes. A framework has been laid to capture loss data which can be mapped to operational risk events to measure the impact quantitatively. Bank has put in place a hierarchical structure to effectively manage operational risk through the formation of internal committee viz., Operational Risk Management Committee (ORMC).

Scope and Nature of Operational Risk Reporting and Measurement Systems

A systematic process for reporting risk events, loss events, "near misses" and non-compliance issues relating to operational risks have been developed and implemented. The information gathered will be used to develop triggers to initiate corrective actions to improve controls. All critical risks and potential loss events are reported to the senior Management/ORMC/IRMC as appropriate for their directions and suggestions.

An Operational Risk Management Policy approved by the Risk Management Committee of the Board details the framework for hedging and/or mitigating operational risk in the Bank. As per the policy, all new products are vetted by the New Product Approval Committee to identify and assess potential operational risks involved and suggest control measures to mitigate the risks.

Approach for Operational Risk Capital Assessment

As per the RBI guidelines, the Bank has adopted Basic Indicator Approach for computing capital charge for Operational Risk. Steps have been initiated to migrate to the Advanced Measurement Approach.

Exposure Related to Counterparty Credit Risk

Counterparty Credit Risk exposures for banks are assessed based on Bank's business requirements and considering counterparty bank's parameters such as CRAR, net worth, NPA level etc. Counterparty exposures for other entities are assessed subject to exposure ceilings as per the Loan Policy of the Bank. Capital for Counterparty Credit Risk exposure is assessed based on Standardized Approach.

The Bank does not recognize bilateral netting. The credit equivalent amount of derivative exposure is calculated using Current Exposure Method and the balance outstanding as on

30th Sep, 2014 is as under:

Particulars	Notional Amount	(Rs. in crores)
		Current Exposure
Foreign exchange contracts	5534.90	152.01
Interest rate contracts	Nil	Nil
Total	5534.90	152.01

Composition of Capital

Disclosures pertaining to composition of capital, including the capital disclosure templates, main features of equity and debt capital instruments and the terms and conditions of equity and debt capital instruments have been disclosed separately on the Bank's website under 'Regulatory Disclosures Section'. The link to this section is

<http://ktkbank.com/ktk/BaselDisclosures.jsp>