

ANNEXURE - II**DISCLOSURE UNDER THE NEW CAPITAL ADEQUACY FRAMEWORK (PILLAR III OF BASEL II GUIDELINES) FOR THE YEAR ENDED 31ST MARCH 2013.****1. SCOPE OF APPLICATION**

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

The Bank has entered in to a Joint venture agreement and holds equity investments to the extent of 15% in M/s Universal Sampo 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

	Particulars	No. of equity shares	Face value per share (₹)	Amount (₹ in crore)
1	Authorized Capital	300000000	10	300.00
2	Issued Capital	188368058	10	188.37
3	Subscribed Capital	188359660	10	188.36
4	Paid up Capital	188343110	10	188.35

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

During the year the Bank has allotted 59020 equity shares to employees under its Employee Stock Option Plan.

The Bank has also raised Tier II capital (Subordinated Debt), with an aggregate value of ₹ 600.00 crore as on 31.03.2013 as per the table below:

Date of allotment	Date of redemption	Rate of Interest	Amount (₹ in Crore)
30-06-2007	30-06-2017	10.50%	120.50
29-03-2008	29-03-2018	10.25%	29.50
27-09-2008	27-09-2018	11.25%	200.00
17-11-2012	17-11-2022	11.00%	250.00
TOTAL			600.00

Breakup of Capital Funds:

The Tier I Capital of the Bank comprises of (₹ in crore)

1	Paid up Capital (Including forfeited shares)	188.35
2	Reserves	2631.47
	Total	2819.82

The Tier II Capital of the Bank comprises of (₹ in crore)

1	Undisclosed reserves	14.95
2	General Provisions and Loss Reserves	142.89
3	Subordinated debts eligible for inclusion in Lower Tier 2 Capital	570.00
	Total	727.84

The total eligible capital comprises of (₹ in crore)

1	Tier I Capital	2819.82
2	Tier II Capital	727.84
	Total	3547.66

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 II for credit, market and operational risk and the capital adequacy ratio are detailed below.

(₹ in crore)

A	Capital requirement for Credit Risk	
	-Portfolios subject to Standardized approach	2160.00
	-Securitization exposures	0
B	Capital requirement for Market Risk	
	Standardized duration approach	128.07
	-Interest rate Risk	87.14
	-Foreign exchange risk	1.80
	-Equity Risk	39.13
C	Capital requirement for Operational Risk	
	-Basic Indicator approach	127.37
D	Total Capital requirement	2415.44
E	Total Capital Funds of the Bank	3547.66
F	Total Risk Weighted Assets	26838.33
G	Capital Adequacy Ratio of the Bank (%)	13.22
H	Tier I CRAR (%)	10.51
I	Tier II CRAR (%)	2.71

3. RISK MANAGEMENT: OBJECTIVES AND ORGANIZATIONAL STRUCTURE

The various risks taken by the Bank during the course of the business development are identified, assessed, measured, monitored, controlled, 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 (IRMC) and the Audit Committee of the Board (ACB) 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 the Credit Policy Committee (CPC), the Asset Liability Management Committee (ALCO) and the 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, ALMC oversees 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 an online comprehensive credit risk rating system for all borrower accounts. Risk rating of borrowers is 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, the Bank rates the 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 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 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 risks.

Credit sanction and related processes

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

1. Sound credit approval process with well laid credit sanctioning criteria is in place.
2. The acceptability of credit exposure is 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 is done to ensure optimal spread of risk across various rating classes to prevent undue risk concentration across any particular industry segments and for monitoring credit risk migration.
4. Sector specific studies are periodically undertaken to highlight risk and opportunities in those sectors.
5. Rating linked exposure norms have been adopted by the Bank.
6. Industry-wise exposure ceilings are based on the industry performance, prospects and the competitiveness of the sector.
7. Separate risk limits are set out 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 of 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.

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. The Bank captures the Concentration risk by monitoring the geographical exposure.

Geographic distribution of credit exposure

(₹ in crore)

Sl. No.	State / Union Territory	Fund based	Non Fund based	Total
1	Andhra Pradesh	2482.00	598.73	3080.73
2	Assam	41.74	32.95	74.69
3	Bihar	14.61	0.01	14.62
4	Chandigarh	54.27	3.99	58.26
5	Chattisgarh	277.51	40.41	317.92
6	Delhi	3169.87	445.79	3615.66
7	Goa	142.67	35.39	178.06
8	Gujarat	265.79	33.90	299.69
9	Haryana	712.41	278.62	991.03
10	Jharkhand	34.34	1.48	35.82
11	Karnataka	10755.90	1089.84	11845.74
12	Kerala	271.62	6.59	278.21
13	Madhya Pradesh	212.02	11.33	223.35
14	Maharashtra	5292.61	764.72	6057.33
15	Odisha	479.14	51.10	530.24
16	Pondicherry	30.26	1.46	31.72
17	Punjab	365.87	57.28	423.15
18	Rajasthan	746.10	21.40	767.50
19	Tamilnadu	2518.48	344.45	2862.93
20	Uttar Pradesh	589.07	146.98	736.05
21	Uttarakhand	49.81	2.25	52.06
22	West Bengal	918.73	131.10	1049.83
	Total gross credit	29424.82	4099.77	33524.59

While determining the 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.

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. The Bank has approved 6 domestic credit rating agencies identified by RBI i.e. CRISIL, CARE, FITCH India, ICRA, Brickwork and SMERA. 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 exposures [fund based & non fund based] after risk mitigation (subject to the standardized approach) in different risk buckets are as under:

(₹ in crore)

SI No	Risk weight	Exposure Outstanding
1	Below 100%	8217.32
2	100%	10196.99
3	More than 100%	3424.50
	Total	21838.81

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 a counterparty while calculating its capital requirements to the extent of risk mitigation provided by the eligible financial collaterals as specified in the Basel II guidelines.

Types of eligible financial collateral / Guarantors:

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

This includes cash, Bank's own deposits, gold (including bullion and jewellery, subject to collateralized jewellery being notionally converted/benchmarked to 99.99% purity), securities issued by the Central and State Governments, Kisan Vikas Patra, 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 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:

- 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;
- 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.
- 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:

(₹ in crore)

Eligible financial collaterals after haircuts	4475.71
Eligible guarantors	1847.36

Definition of Non-Performing Assets

The 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 including geographical distribution of exposures

(₹ in crore)

	Domestic	Overseas	Total
Fund Based	29424.82	Nil	29424.82
Non Fund based	4099.77	Nil	4099.77
Total	33524.59	Nil	33524.59

B. Distribution of Credit Exposure by Industry Sector

(₹ in crore)

Sl.No.	Industry Classification	Fund based	Non funded
1	Coal and Mining	99.08	2.29
2	Iron and Steel	764.08	80.46
3	Metal and Metal Products	327.69	95.16
4	Other Engineering	548.40	224.41
5	Wood Based Industries	72.29	152.53
6	Electronics	24.00	3.65
7	Cotton Textiles	753.59	98.71
8	Jute Textiles	6.08	0.75
9	Other Textiles	775.76	88.25
10	Tea Industry	51.85	0.28
11	Khandasari and Sugar	33.60	2.11
12	Vegetable Oil	16.62	0.05
13	Tobacco and Tobacco Products	0.88	0.00
14	Paper and paper Products	225.36	18.46
15	Rubber and Rubber Products	13.12	4.23
16	Plastic and Plastic Products	225.85	72.96
17	Chemicals , Dyes	75.96	22.28
18	Drugs and Pharmaceuticals	104.83	35.18
19	Cement and Cement products	321.23	18.31
20	Leather and Leather products	39.92	18.49
21	Petroleum Products	128.51	1.53
22	Distilleries, Brewaries including soft drinks	27.63	1.54
23	Cashewnut Processing	16.48	0.00
24	Rice, Flour, Dhal Mills	64.28	6.00
25	Marine Products/Processing	0.01	0.00
26	Food and Food Products	129.79	4.98
27	Gems and Jewellery	529.99	72.14
28	Automobiles	324.72	13.00
29	Computer Software and Computer Hardware	31.76	22.76
30	All Other Industries	621.86	195.18
	TOTAL INDUSTRIAL ADVANCES	6355.22	1255.69

The Industry/sector wherein the Bank's exposure in the related Industry/sector has exceeded 5 percent of total gross credit exposure is furnished below.

Sl No	Industry / sectors classification	Percentage of the total credit exposure
1	Infrastructure advances	11.10

C. Residual contractual maturity of Advances and Investments

(₹ in crore)

Sl No	Maturity Buckets	Advances	Investments
1	1 Day	613.44	310.69
2	2 to 7 Days	179.93	175.03
3	8 to 14 Days	224.45	0
4	15 to 28 Days	294.54	0
5	29 Days to 3 Months	1620.41	145.57
6	Over 3 Months to 6 Months	1719.59	135.33
7	Over 6 Months to 12 Months	3555.07	216.32
8	Over 1 Year to 3 Years	11376.94	1519.76
9	Over 3 Years to 5 Years	2618.14	1515.18
10	Over 5 Years	3005.17	9414.60
	Total	25207.68	13432.48

D. Classification of Non Performing Advances

(₹ in crore)

		Current Year	Previous Year
A	Amount of NPA's (Gross)	638.86	684.72
	-Substandard	342.41	362.44
	-Doubtful 1	216.00	116.37
	-Doubtful 2	37.53	173.34
	-Doubtful 3	15.81	9.84
	-Loss	27.11	22.73
B	Net NPAs	377.75	435.20

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

(₹ in crore)

		Current Year	Previous Year
A	Amount of Non performing Investments	12.85	Nil
B	Amount of Provision held for Non performing Investments	12.85	Nil
C	Movement of provisions for depreciation on Investments		
1	Opening balance	119.36	68.54
2	Add: Provisions made during the year	NIL	50.82
3	Less: Write off/write back of excess provisions	31.44	Nil
4	Closing balance	87.92	119.36

5. MARKET RISK & LIQUIDITY RISK

The Bank has put in place a 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 and internal limits and ensures 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, Overnight, Daylight, Aggregate Gap, Individual Gap Value at Risk (VaR) limits for Forex, inter-bank dealings and various investment limits.

For market risk management the Bank has a Mid-Office. The functions of Mid-Office are handled by the RMD

The Board, IRMC & ALCO are overseeing the market risk management of the bank, procedures thereof, implementation of risk management guidelines issued by the 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/mitigations are discussed in ALCO and based on views or 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

The 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 under implementation.

The capital requirements for market risk are detailed below:

(₹ in crore)

SI No	Risk Category	Capital Charge
I	Interest Rate	87.14
II	Equity	39.13
III	Foreign Exchange, Gold and Derivatives	1.80
IV	Total Capital Charge for market Risk (I+II+III)	128.07

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

Interest rate risk is managed through gap analysis and duration gap analysis. Prudential limits have been fixed for impact on net Interest Income (NII), Net Interest margin (NIM), etc and monitoring Return on Assets (ROA).

The economic value i.e. impact on the capital fund due to change in interest rate by 200 bps on the economic value, is assessed at monthly intervals through duration gap method. As a prudential measure, a limit has been fixed for net duration gap of the assets and liabilities and the same is monitored at monthly intervals.

Earnings at Risk for 200 bps interest rate shock is estimated at ₹ 30.12 crore and change in the Market value of equity for 200 bps interest rate shock is 5.15%.

7. OPERATIONAL RISK

Strategies and Processes

The 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. The Bank has put in place a hierarchical structure to effectively manage operational risks through formation of an internal committee, viz., 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 IRMC 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 to 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 approaches.