Karnataka Bank Limited

DISCLOSURE UNDER THE NEW CAPITAL ADEQUACY FRAMEWORK (BASEL II GUIDELINES) FOR THE YEAR ENDED 31ST MARCH 2011

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 presently is not involved in insurance business. However, it 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 considered for 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	Authorised Capital	200000000	10	200.00
2	Issued Capital	188215600	10	188.22
3	Subscribed Capital	188207202	10	188.21
4	Called up/Paid up Capital	188190652	10	188.20

The Bank's shares are listed on the National Stock Exchange of India Ltd and Bombay Stock Exchange Ltd., Mumbai. Pursuant to the Rights issue in the ratio of 2:5, the Bank has allotted 5,37,68,615 equity shares of ₹ 10/- each during the year, at a premium of ₹ 75/- per share aggregating to ₹ 457.03 crore. In accordance with the provisions of section 78(2) (c) of the Company's Act 1956 and as provided under the Letter of Offer dated February 18,2010 the expenses incurred in this connection, aggregating to ₹ 3.15 crore have been charged off to the share premium account.

During the year the Bank has allotted 4,45,715 equity shares to employees under it's Employee Stock Option Scheme.

The Bank had also raised Tier II capital (Subordinated Debt)of aggregate value of ₹ 350.00 crore outstanding as on 31st March, 2011, as per the details given 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
TOTAL			350.00

Breakup of Capital Funds

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

1	Paid up Capital (including forfeited shares)	188.20
2	Reserves	2227.67
	Total	2415.87

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

1	Undisclosed reserves	12.65
2	General Provisions and Loss Reserves	79.52
3	Subordinated debts eligible for inclusion in Lower Tier 2 Capital	350.00
	Total	442.17

The Total eligible capital comprises of (₹ in crore)

1	Tier I Capital	2415.87
2	Tier II Capital	442.17
	Total	2858.04

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 is detailed below.

(₹ in crore)

A	Capital requirement for Credit Risk	
	-Portfolios subject to Standardized approach	1726.18
	-Securitization exposures	0.00
B	Capital requirement for Market Risk	
	Standardized duration approach	102.60
	-Interest Rate Risk	67.28
	-Foreign Exchange Risk	2.16
	-Equity Risk	33.16
C	Capital requirement for Operational Risk	
	-Basic Indicator approach	101.02
D	Total Capital requirement	1929.80
E	Total Capital Funds of the Bank	2859.18
F	Total Risk Weighted Assets	21442.34
G	Capital Adequacy Ratio of the Bank (%)	13.33
H	Tier I CRAR (%)	11.27
I	Tier II CRAR (%)	2.06

3. RISK MANAGEMENT: OBJECTIVES AND ORGANIZATION STRUCTURE

The various risks taken by the Bank during the course of the business development are identified, measured, controlled, monitored 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 'Risk Management Policy', duly approved by the Board, in place. The Board sets the overall risk appetite and philosophy for the Bank. The Board of Directors, the Integrated Risk Management and the Audit Committees 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.

The Credit Policy Committee deals with credit policies and procedures. The Asset Liability Management Committee deals with Asset Liability Management (ALM) and Investment Policy of the Bank and The Operational Risk Management Committee formulates policies and procedures for managing operational risk.

4. CREDIT RISK MANAGEMENT

The Bank has developed an online comprehensive risk rating system for all borrower accounts with aggregate fund based exposures of ₹ 25.00 lakh and above or aggregate non-fund based exposure of ₹ 200 lakhs and above, irrespective of the amount of fund based exposure. 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 specific characteristics, industry specific characteristics etc. 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. In addition to the above, 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 concept is a leading principle for all business activities of the Bank.

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 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 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 structural limits and borrower limits based on creditworthiness. These include:

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 is capturing the concentration risk by monitoring the geographical exposure.

Geographic Concentration

(₹ in crore)

Sl No	State/Union Territory	Fund Based	Non Fund Based	Total
1	Andhra Pradesh	1605.56	339.02	1944.58
2	Assam	22.54	7.66	30.20
3	Bihar	5.11	0	5.11
4	Chandigarh	38.23	6.83	45.06
5	Chhattisgarh	145.71	15.37	161.08
6	Delhi	2229.72	302.17	2531.89
7	Goa	93.08	15.15	108.23
8	Gujarat	218.37	20.9	239.27
9	Haryana	501.79	193.08	694.87
10	Jharkhand	15.69	1.42	17.11
11	Karnataka	5908.28	601.71	6509.99
12	Kerala	141.6	2.61	144.21
13	Madhya Pradesh	123.53	4.17	127.70
14	Maharashtra	2781.98	561.91	3343.89
15	Orissa	358.18	39.74	397.92
16	Pondicherry	16.47	0.49	16.96
17	Punjab	223.62	24.39	248.01
18	Rajasthan	587.55	14.92	602.47
19	Tamil Nadu	1802.6	166.49	1969.09
20	Uttar Pradesh	275.94	60.65	336.59
21	Uttarakhand	17.34	0.66	18.00
22	West Bengal	583.14	77.67	660.81
	TOTAL GROSS BANK CREDIT	17696.03	2457.01	20153.04

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 also monitors the rating-wise distribution of its borrowers.

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 will use the same in calculation of risk weighted assets. The Bank has approved 4 domestic credit rating agencies identified by RBI i.e CRISIL, CARE, FITCH India and ICRA. 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:

b) Other Exposures

(₹ in crore)

Sl No	Risk weight	Exposure Outstanding
1	Below 100%	5322.56
2	100%	9623.67
3	More than 100%	2046.79
	Total	16993.02

Credit Risk Mitigation: Disclosures for Standardized Approach

As stipulated by the RBI guidelines, the Bank uses the comprehensive approach for collateral valuation. 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 BaseI II guidelines.

Types of eligible financial collaterals / 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's 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, Kisan Vikas Patras, 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. In addition to the above, in the case of NPA accounts, the following collaterals are considered, as stipulated by the RBI under Basel II guidelines:

(i) Land and building which are valued by an expert valuer and where the valuation is not more than three years old and (ii) Plant and machinery in good working condition at a value not higher than the depreciated value as reflected in the audited balance sheet of the borrower, which is not older than eighteen months.

Eligible Guarantors (counter-guarantors):

Credit protection given by the following entities will be recognized:

(i) Sovereigns, sovereign entities (including BIS, IMF, European Central Bank and European Community as well as those MDBs, ECGC and CGTSI), banks and primary dealers with a lower risk weight than the counterparty;

(ii) Other entities rated AA (-) or better. This would include guarantee cover provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor. The rating of the guarantor should be an entity rating which has factored in all the liabilities and commitments (including guarantees) of the entity.

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	2341.33
Eligible guarantors	814.16

Definition of Non-Performing Assets Bank has adopted the definition of the ‘past due’ and ‘impaired’ (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

(₹ in crore)

	Domestic	Overseas	Total
Fund Based	17696.03	0	17696.03
Non Fund based	2457.01	0	2457.01
Total	20153.04	0	20153.04

B. Distribution of Credit Exposure by Industry Sector (₹ in crore)

Sl No	INDUSTRY CLASSIFICATION	FUND BASED	NON FUNDED
1	Coal and Mining	102.09	26.62
2	Iron and Steel	291.16	56.29
3	Metal and Metal Products	90.42	10.42
4	Other Engineering	327.76	155.09
5	Wood Based Industries	57.72	49.24
6	Electronics	33.13	2.15
7	Cotton Textile	667.07	73.57
8	Jute Textile	3.53	0.00
9	Other Textiles	595.25	51.59
10	Tea Industry	31.69	0.27
11	Kandasari and Sugar	28.97	1.02
12	Vegetable Oil	8.41	0.00
13	Tobbaco and Tobbaco Products	0.39	0.00
14	Paper and Paper Products	148.58	32.67
15	Rubber and Rubber Products	10.23	2.92
16	Plastic and Plastic Products	186.51	18.68
17	Chemicals, Dyes	52.63	11.64
18	Drugs and Pharmaceuticals	72.77	17.19
19	Cement and Cement Products	279.49	21.88
20	Leather and Leather Products	36.91	10.85
21	Petroleum Products	106.48	2.10
22	Food and Food Products	51.13	1.81
23	Gems and Jewellery	524.90	88.95
24	Automobiles	135.66	20.47
25	Computer Software and Computer Hardware	23.06	16.36
26	All Other Industries	355.29	103.03
27	Infrastructure advances	2565.64	272.60
	TOTAL INDUSTRIAL ADVANCE	6786.87	1047.41

The details of the industry/sectors wherein the Bank's exposure in the related industry/sector has exceeded the five per cent of total gross credit exposure will be furnished as detailed here below.

Sl No	Industry / Sectors Classification	Percentage of the total Credit Exposure
1	Infrastructure advances	14.08%

C. Residual Contractual Maturity Breakdown Advances and Investments (₹ in crore)

Maturity Buckets	Advances	Investments
1 day	558.03	308.77
2 to 7 days	104.43	774.50
8 to 14 days	105.02	119.60
15-28 Days	163.28	49.96
29 Days to 3 Months	1030.56	66.58
Over 3 Months to 6 Months	1124.73	5.25
Over 6 Months to 12 Months	2440.08	46.90
Over 1 Year to 3 years	8557.78	946.94
Over 3 Years to 5 Years	1777.73	1395.49
Over 5 Years	1486.43	7792.35
Total	17348.07	11506.34

D. Classification of Non-Performing Advances

(₹ in crore)

		Current Year	Previous Year
A	Amount of NPA's (Gross)	702.17	549.64
	-Substandard	182.93	151.14
	-Doubtful 1	187.90	194.87
	-Doubtful 2	203.16	95.71
	-Doubtful 3	38.27	53.02
	-Loss	89.91	54.90
B	Net NPAs	281.47	188.61

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

(₹ in crore)

		Current Year	Previous Year
A	Amount of Non performing Investments	0.00	0.00
B	Amount of Provision held for Non-performing Investments	0.00	0.00
C	Movement of provisions for depreciation on Investments		
	a) Opening balance	29.61	47.83
	b) Add: Provisions made during the year	38.93	0.00
	c) Less: Write off/write back of excess provisions	0.00	18.22
	d) Closing balance	68.54	29.61

5. MARKET RISK & LIQUIDITY RISK

The Bank has put in place an Integrated Treasury Policy and Asset Liability Management (ALM) policy approved by the Board 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 investment limits etc.

For the Market Risk Management the Bank has a Mid Office. The functions of Mid Office are handled by Integrated Risk Management Department.

The Bank's Board, IRMC and the ALCO oversee the market risk management of the Bank, procedures thereof, implementation of 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 meetings 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

The Bank has adopted the Standardized Duration Approach as prescribed by RBI for computation of capital charge for market risk and is already fully compliant with such RBI guidelines. The 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: (₹ in crore)

Sl No	Risk Category	Capital Charge
I	Interest Rate	67.28
II	Equity	33.16
III	Foreign Exchange, Gold and Derivatives	2.16
IV	Total Capital Charge for market Risk (I+II+III)	102.60

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), Minimum ROA. The economic value i.e. impact on the capital fund due to change in interest rate by 200 basic points (bps) on the economic value is assessed on 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 a 200 bps interest rate shock is estimated as ₹ 11.10 crore and change in the Market value of Equity for a 200 bps interest rate shock is 8.34 per cent.

7. OPERATIONAL RISK:

Strategies and Processes

The Bank has initiated several measures to manage operational risk through identification, assessment and monitoring. 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 risk through the formation of an 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 Board details the framework for hedging and/or mitigating operational risk in the Bank. As per the policy, all new products are being 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.

8. COUNTRY RISK

The Bank has put in place a risk monitoring system for the management of country risk. The Bank uses the nine-category classification i.e. insignificant, low, moderately low, moderate, moderately high, high, very high, restricted and off-credit. The ratings of countries are being undertaken at monthly intervals or at more frequent intervals if the situation so warrant i.e. in case of a significant change in the condition of a country involving sharp deterioration of its ratings. Exposure to a country includes all credit-related lending, trading and investment activities, whether cross border or locally funded. The Bank has set up exposure limits for each risk category as also per country.