Canara Bank

May 11, 2018

Summary of rated instruments

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Additional Tier-I Bonds Programme – Basel III	1,500	1,500	[ICRA]AA (hyb) (negative); outstanding
Tier-II Bonds Programme – Basel III	7,900	7,900	[ICRA]AAA (hyb) (negative); outstanding
Lower Tier-II Bonds Programme	325	325	[ICRA]AAA (negative); outstanding
Certificate of Deposits Programme	50,000	20,000	[ICRA]A1+; outstanding -
Total	**61,400**	**29,725**	

*Instrument details are provided in Annexure-1

Rating action

ICRA has reduced the rated amount against the certificate of deposits (CoD) programme of the Canara bank (Canara) to Rs.20,000 crore from Rs.50,000 crore rated earlier. ICRA has a rated the above CoD programme of the bank at [ICRA]A1+ (pronounced ICRA A one plus)[1]. The reduction in rated amount is as per the request of the bank.

ICRA also has long term rating of [ICRA]AA (hyb) (pronounced ICRA double A hybrid) outstanding on the Rs. 1,500-crore[2] Basel III compliant additional tier-I bond programme, rating of [ICRA]AAA(hyb) (pronounced ICRA triple A hybrid) outstanding on the Rs. 7,900-crore Basel III compliant tier-II bond programme and rating of [ICRA]AAA (pronounced ICRA triple A) outstanding on the Rs. 325-crore lower tier-II bond programme of the bank. The outlook on the long-term ratings is negative.

The letters “hyb” in parenthesis suffixed to a rating symbol stand for “hybrid”, indicating that the rated instrument is a hybrid subordinated instrument with equity-like loss-absorption features. Such features may translate into higher levels of rating transition and loss-severity vis-à-vis conventional debt instruments.

The rating for the bank’s Basel III compliant tier-I bonds is two notches below the Basel III compliant tier-II bonds as these instruments have the following loss-absorption features that make them riskier:

- *The bank has full discretion at all times to cancel the distribution or payments and the cancellation shall not be an event of default*
- *The minimum capital conservation ratio applicable to commercial banks may restrict the bank from servicing these tier-I bonds in case the common equity tier-I falls below the limit prescribed by the Reserve Bank of India (RBI)*

These tier-I bonds are expected to absorb losses through the write-down mechanism at the objective pre-specified trigger point fixed at the bank’s common equity tier-I ratio, as prescribed by the RBI. The ratio is 5.5% before March 31, 2019 and thereafter 6.125% of the total risk weighted assets of the bank or when the point of non-viability (PONV) trigger is breached, in the RBI’s opinion.

[1] For complete rating scale and definitions, please refer to ICRA’s website (www.icra.in) or other ICRA rating publications

[2] *100 lakh = 1 crore = 10 million*

Basel III compliant tier-I bonds also have the following features, which makes them riskier.

- *Coupon payments, which are non-cumulative, are discretionary and the bank has the full discretion at all times to cancel them*
- *Coupon can be paid out of current year profits. However, if current year profit is not sufficient, or if the payment of coupon is likely to result in a loss, the coupon payment can be made from reserves and surpluses created through the appropriation of profits (including statutory reserves). But the coupon payment made by utilising reserves is subject to the bank meeting the minimum regulatory requirements for CET I, Tier I and total capital ratios (including capital conservation buffer, CCB) at all times as prescribed by the RBI under Basel III regulations*

Rationale

The ratings continue to factor in the majority Government of India (GoI) ownership (66.3% stake held by the GoI as on December 31, 2017), the demonstrated sovereign support through timely capital infusion during the past two fiscals, GoI's recapitalisation plan for public sector banks (PSBs) in the current fiscal and the established retail franchise supporting its good deposit and liquidity profile. Subsequent to the capital infusion by the GoI in February 2018, the bank's reported Tier-1, which was 9.6% as on December 31, 2017, will improve to ~10.9% as against the minimum regulatory requirement of 9.5% (including capital conservation buffer of 2.5%), thereby significantly improving capital cushion.

The negative outlook on the rating continues to factor in the stressed asset quality indicators (gross NPA at 10.4% and net NPAs of 6.8% as on December 31, 2017) stemming from continued slippages and subdued recoveries and the consequent higher credit provisioning requirements resulting in modest net profitability. With recent regulatory changes whereby the RBI has discontinued all the earlier schemes for the resolution of stressed assets, ICRA expects the slippages and the credit provisions for the bank to surge during the next few quarters given its large stressed exposures[3], thereby keeping internal capital generation under pressure. Internal capital generation is also likely to be impacted by the continued rise in bond yields, which is expected to result in mark-to-market losses for the bank on its debt investment portfolio in the near term. Accordingly, despite the recent capital infusion by the GoI in February 2018, the bank will continue to require sizeable capital infusions from the GoI, divestments and other sources to absorb credit losses and support its business growth while maintaining capital cushion over the medium term. In the backdrop of weak internal capital generation and large capital requirements, the rating outlook has been retained at negative.

The rating on the Basel III compliant tier-I bonds is two notches lower than the rating on the tier-II instruments because of continued asset quality pressure and consequent pressure on the bank's internal capital generation. Thus, the bank is likely to remain dependent on the sale of non-core assets to maintain profitable operations and prevent erosion of distributable reserves[4]. The distributable reserves that can be used for servicing the coupon in a situation of inadequate profits or a loss during the year, stood comfortable at 5.9%[5] of risk weighted assets as on December 31, 2017, which is higher than the weighted average of ~4.5% for PSBs.

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[3] The bank had a special mention account 2 (SMA-2) totalling Rs. 14,879 crore (4.3% of standard advances) as on December 31, 2017, which also included loans under regulatory forbearance schemes like Strategic Debt Restructuring - SDR, flexible restructuring and the scheme for sustainable structuring of stressed assets (S4A), all of which stand discontinued

[4] Calculated as per the amendment in Basel III capital regulations for AT-I bonds by the RBI, vide its circular dated February 2, 2017. As per the amended definition, distributable reserves include all reserves created through appropriation from the profit and loss account

[5] Including profits for 9M FY2018

Outlook: Negative

The outlook is Negative as ICRA expects slippages to remain high in the near term and continue exerting pressure on the asset quality. This would increase credit provisioning and impact net profitability. The outlook would be changed to Stable if asset quality indicators stabilise and, consequently, better clarity emerges on profitability and capitalisation levels. The rating would be downgraded if the bank continues to witness significant deterioration in asset quality and earnings profile without commensurate capital raising or divestments on non-core assets.

Key rating drivers

Credit strengths

Sovereign support in the form of regular capital infusion – Canara is a large-sized public-sector bank with a market share of 4.7% each in advances and deposits as on December 31, 2017. The GoI holds a majority stake with 66.3% shareholding of the bank as on December 31, 2017. The GoI infused total capital of Rs. 1,692 crore into the bank during FY2016 and FY2017 (0.5% of risk weighted assets as on March 31, 2017) and allotted Rs. 4,865 crore capital for the current fiscal (1.4% of risk weighted assets as on December 31, 2017) as part of its PSB recapitalisation plan.

Good advance growth compared to PSBs and comfortable in meeting priority sector lending targets - ICRA notes that the bank's gross advances grew 5.6% and 12.5% YoY in FY2017 and 9M FY2018, respectively, driven by growth across all segments. This was better compared to the PSB average growth of 0.5% and 3.8%, respectively. The credit to deposit ratio significantly improved to 74.1% as on December 31, 2017 from 67.7% as on March 31, 2016. Going forward, ICRA expects the bank to continue its good growth momentum (better than the PSB average) and comfortably achieve growth of 12-15% per annum during FY2018-FY2019. Further, the bank's share of total priority sector lending advances was good compared to PSBs at 52.6% as on December 31, 2017 (against the minimum requirement of 40.0%), with priority advance to agriculture at 22.2% (18.0%) and the weaker section at 12.6% (10.0%).

Established retail franchise in South India - Canara has a long-standing presence spanning more than 100 years with an established retail franchise in South India. The five southern states constituted 45% of the bank's total branch network of 6,179 as on December 31, 2017. Though the bank's CASA has improved to 30.1%, as on December 31, 2016 (post the Government's demonetisation exercise), from 27.2% as on September 30, 2016 and further to 31.3% as on December 31, 2017, the same remains low compared to the PSB average of 38%. Scope for further improvement in the deposit profile could be limited by the required growth in deposits to meet its advance growth targets. The cost of interest-bearing funds for the bank stood higher at 5.4% during 9M FY2018 as against 5.2% for PSBs because of relatively lower CASA in the total deposit base. The bank has a good liquidity profile with a liquidity coverage ratio of 108.7% as on September 30, 2017 as against the regulatory requirement of 90%, w.e.f. January 1, 2018.

Credit challenges

Stressed asset quality with continued pressure in the near term – Canara's gross NPAs increased steeply to 9.4% as on March 31, 2016 from 3.9% as on March 31, 2015 post the RBI's asset quality review. It remained elevated at 10.4% as on December 31, 2017 because of high slippages and subdued recoveries. As on December 31, 2017, the bank's NPA provision cover was low compared to its peer PSBs at 37.3% (34.2% as on March 31, 2016) as well as the PSB average of around 46%, resulting in net NPAs of 6.8%, which is higher than the PSBs rated in the AAA rating category.

As on December 31, 2017, Canara's share of standard restructured advances at around 2.0% of standard advances. The bank's SMA-2 portfolio also remains high at 4.3% of standard advances. This large portion of vulnerable assets would lead to incremental pressure on the bank's asset quality in the near term, especially given the RBI's recent discontinuance of all the earlier schemes of resolution of stressed assets. The bank has not made any ARC sale in FY2017 and 9M FY2018, and the security receipt outstanding was modest compared to peers at 0.5% of total advances. Canara's reported gross NPAs include 29 large corporate accounts referred to NCLT[6] and constitute 3.9% of gross advances. The bank had a provision cover of 45% on these accounts as on December 31, 2017. In a situation of the loss upon the resolution of these accounts being higher than the provisions carried by the bank, it will translate into further provisioning requirements.

Profitability to remain under pressure because of higher credit cost – While NIMs (as % of average total assets – ATA) remained stable at 1.8% during FY2016 and FY2017, it increased to 2.1% during 9M FY2018 because of a decline in the cost of interest-bearing funds, interest income on tax refunds and improvement in the credit deposit ratio. However, operating expenses (as % of ATA) increased to 1.5% in FY2017 from 1.4% in FY2016 and further to 1.6% in 9M FY2018 with increase in employee and other expenses. With asset quality indicators remaining weak, the credit provisions (as % of ATA) remained high at 1.8% in FY2016 and 1.3% each in FY2017 and 9M FY2018, surpassing core operating profits. The credit provisions are also high compared to the historical levels of 0.3-0.5% on account of ageing of NPAs and higher provisions required for NCLT-referred accounts. Despite credit provisions surpassing core operating profits, the bank has been able to report some profit supported by treasury activities entailing the sale of non-core assets and gains on the sale of bonds subsequent to a decline in bond yields until Q2 FY2018. Treasury profits improved to 0.5% in FY2017 from 0.2% (of ATA) in FY2016 aided by favourable bond yield movement and sale of non-core assets, but reduced to 0.1% in 9M FY2018 with the firming up of bond yields and consequent mark-to-market losses. In line with this, the bank reported net profitability (as % of ATA) of 0.2% in FY2017 (net losses of -0.5% in FY2016) and 0.1% in 9M FY2018. Though the bank's operating profit is expected to be steady for the coming quarters, the likely increase in credit provision requirements and continued mark-to-market losses in debt investments would impact earnings, going forward, unless supported by the continued divestment of non-core assets.

Sizeable capital to absorb credit provisioning, support growth and maintain capital cushion in relation to rating category - The bank's capitalisation profile was moderate with tier-I at 9.6% as on December 31, 2017, which would increase to ~10.9%, adjusted for the capital allotted by the GoI in February 2018. Though the bank has good capital cushion in relation to the minimum tier-I regulatory requirement of 9.5% (including capital conservation buffer of 2.5%) by March 2019, the bank would need further capital infusion to support its medium term growth, considering the incremental pressure on internal capital generation. Given the relatively lower provision cover compared to the PSB average, the bank's solvency was also weak with net NPA/net worth at 88% as on December 31, 2017 against the PSB average of around 78% and much lower for PSBs rated in the AAA rating category. As per ICRA's estimates, the bank would require incremental tier-I capital at 30-40%[7] of its current market capitalisation during FY2018 and FY2019. The bank has been divesting its stake in its subsidiaries and a few non-core investments, which is expected to continue, and supports its capital requirement to a large extent. The bank also has board approval to raise Rs. 4,500 crore of capital through non-Government sources (1.3% of the bank's risk weighted assets).

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below.

Links to applicable criteria:
ICRA Rating Methodology for Banks

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[6] National Company Law Tribunal. Insolvency and bankruptcy proceedings against stressed borrowers are done in NCLT
[7] Assuming a 1% buffer over regulatory capital levels, 7-9% growth in risk weighted assets and 4-6% internal generation

About the bank:

Canara is a large nationalised bank with the GoI owning a majority stake of 66.3% as on December 31, 2017. Headquartered in Bangalore, Canara has a pan-India presence, directly through its network of 6,179 branches and through its seven subsidiaries, an associate company and a joint venture. The Group provides a wide range of financial offerings including asset management, online trading, factoring and housing finance. As on December 31, 2017, the bank had 8.2 crore strong clientele accounts.

Key financial indicators (Audited)

	FY2016	FY2017	9M FY2017	9M FY2018
Net Interest Income (Rs. crore)	9,763	9,872	7,164	9176
Profit before Tax (Rs. crore)	-3,186	1,642	1,378	750
Profit after Tax (Rs. crore)	-2,813	1,122	908	638
Net Advances (Rs. crore)	3,24,715	3,42,009	3,31,636	3,73,123
Total Assets (Rs. crore) (adjusted for revaluation reserve)	5,47,516	5,78,146	585,624	5,94,453
% CET 1	8.2%	8.9%	8.1%	8.8%
% Tier 1	8.8%	9.8%	9.0%	9.6%
% CRAR	11.1%	12.9%	12.3%	12.5%
% Net Interest Margin / Average Total Assets	1.8%	1.8%	1.7%	2.1%
% Net Profit / Average Total Assets	-0.5%	0.2%	0.2%	0.1%
% Return on Net Worth	-10.8%	4.1%	4.6%	3.0%
% Gross NPAs	9.4%	9.6%	10.0%	10.4%
% Net NPAs	6.4%	6.3%	6.7%	6.8%
% Provision Coverage incl Technical Write-offs	50.1%	55.6%	52.5%	55.8%
% Net NPA / Net Worth	79.6%	76.5%	82.5%	87.7%

Note: Amounts in Rs. Crore
Source: Canara Bank, ICRA Calculations

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

Instrument	Current Rating (FY2019)				Chronology of Rating History for the past 3 years			
	Type	Amount rated (Rs. crore)	Amount Oustanding (Rs. crore)		FY2018	FY2017	FY2016	
				May-18	Mar-18	Dec-16	Feb-16	Apr-15
Tier-II Bonds – Basel III	Long Term	7,900	7,900	[[ICRA]AAA (hyb) (negative)	[[ICRA]AAA (hyb) (negative)	[[ICRA]AAA (hyb) (negative)	[[ICRA]AAA (hyb) (negative)	[[ICRA]AAA (hyb) (Stable)
Lower Tier-II Bonds	Long Term	325	325	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (negative)	[ICRA]AAA (Stable)
Additional Tier-I Bonds	Long Term	1,500	1,500	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (negative)	[ICRA]AA (hyb) (Stable)
Certificate of Deposits	Short-term	20,000	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

Complexity level of the rated instrument:

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument Details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE476A08050	Tier-II Bonds - Basel III	27-Apr-16	8.40%	27-Apr-26	3,000	[ICRA]AAA (hyb) (negative)
INE476A08043	Tier-II Bonds - Basel III	7-Jan-16	8.40%	7-Jan-26	900	[ICRA]AAA (hyb) (negative)
NE476A09264	Tier-II Bonds - Basel III	31-Dec-15	8.40%	31-Dec-25	1,500	[ICRA]AAA (hyb) (negative)
INE476A09256	Tier-II Bonds - Basel III	27-Mar-14	9.70%	27-Mar-24	1,000	[ICRA]AAA (hyb) (negative)
INE476A09249	Tier-II Bonds - Basel III	3-Jan-14	9.73%	3-Jan-24	1,500	[ICRA]AAA (hyb) (negative)
INE476A09199	Lower Tier-II Bonds	16-Jan-09	8.08%	16-Jan-19	325	[ICRA]AAA (negative)
INE476A08035	Additional Tier-I Bonds	5-Mar-15	9.55%	Perpetual	1,500	[ICRA]AA (hyb) (negative)
-	Certificate of Deposits	-	-	7-365 days	20,000	[ICRA]A1+

Source: Canara Bank

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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.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

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