Canara Bank

May 28, 2018

Summary of rated instruments

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

*Instrument details are provided in Annexure-1

^ Amount outstanding as on March 31, 2018 is Nil

Material Event

Canara Bank (Canara / the bank) has announced its Q4 FY2018 and FY2018 results. According to the results, the bank has reported substantial loss before taxes of Rs.7,310.4 crore and Rs.6,560.9 crore for Q4 FY2018 and FY2018 respectively. Impact of the aforesaid loss on the capital ratios of the bank was however partially offset by the equity infusion of Rs.4,865 crore by the Government of India (GoI) in March 2018.

ICRA has ratings outstanding of [ICRA]AA (hyb) (pronounced ICRA double A hybrid) on the Rs. 1,500 crore[1] Basel III compliant additional tier-I bond programme, [ICRA]AAA(hyb) (pronounced ICRA triple A hybrid) on the Rs.7,900 crore Basel III compliant tier-II bond programme and the [ICRA]AAA (pronounced ICRA triple A) rating on the Rs. 325-crore lower tier-II bond programme of Canara Bank (Canara)[2]. The outlook on the long-term ratings is negative. ICRA also has short-term rating of [ICRA]A1+ (pronounced ICRA A one plus) outstanding on the Rs. 20,000-crore certificate of deposits programme of the bank.

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)*

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

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

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.

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*

Update

Notwithstanding the growth in net interest income (NII) and expansion in net interest margins (NIM) to 2.0% of average total assets (ATA) during FY2018 (from 1.8% in FY2017) and the consequent growth in core operating profits, Canara Bank reported substantial losses in FY2018. The losses were mainly because of significantly higher credit provisions attributed to higher slippages during the year. However, despite the losses, the bank's capital ratios remained supported by the equity infusion of Rs.4,865 crore by GoI in March 2018. The bank has not taken any regulatory dispensation in its FY2018 financial results and the reported capital ratios are satisfactory at common equity tier 1 (CET-1) of 9.51%, tier-1 of 10.30% and total capital to risk weighted assets ratio (CRAR) of 13.22% as on March 31, 2018 – higher than the regulatory requirements[3].

With elevated Net NPAs at 7.48% and low provision cover of ~40% as on March 31, 2018, the credit cost is expected to surpass core operating profits during FY2019, which would result in weak profitability and a need to raise equity to maintain cushion over regulatory capital requirements. In ICRA's opinion, in a scenario of 5-7% growth in RWA during FY2019, the bank would require capital in the range of Rs.5,500-6,000 crore (30-33% of its current market capitalization) to maintain Tier-1 capital ratio at ~10.5%[4] in March 2019. In ICRA's view, a part of the above capital is expected to be raised through divestments of non-core assets thereby lowering the overall requirement of fresh equity capital raise. The bank's management has guided a capital raise plans of Rs.4,500 crore in FY2019 in addition to monetization of certain non-core assets. Given its current rating level, ICRA expects the bank to continue to maintain a comfortable capital cushion over the regulatory minimum requirement; failing which is credit rating would be under pressure. ICRA will continue to monitor developments in Canara Bank's capital raising activities.

The bank has reported net NPA higher than the threshold criteria of 6% for inclusion in prompt corrective action (PCA) framework of the Reserve Bank of India (RBI) for past 9 consecutive quarters, however management has guided reduction in net NPAs to ~5.5% by September 2018, which shall prevent its inclusion under PCA.. Further, the bank's capital requirement would also be determined by the extent of recovery/haircuts in the existing and likely stressed accounts undergoing resolution.

Outlook: Negative

The negative outlook factors in weak outlook on profitability, weak solvency levels and significant capital requirements to maintain capital cushion in line with rating category. ICRA expects Canara Bank to continue to maintain a comfortable

[3] *CET-1 of 7.375%, Tier-1 of 8.875% and CRAR of 10.875% as on March 31, 2018 including capital conservation buffer (CCB) of 1.875%.*
[4] *Assuming 1% buffer over minimum regulatory Tier I capital level of 9.5% including CCB of 2.5%*

capital cushion over the regulatory requirement. Accordingly, the rating may be revised downwards in case the bank is unable to raise sufficient capital in a timely manner. Inclusion of the bank into PCA framework which would restrict growth and increase capital requirements will also be a rating negative.

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 4.3% and 4.1% each in advances and deposits as on March 31, 2018. The GoI holds a majority stake with 72.6% shareholding of the bank as on March 31, 2018 (66.3% as on December 31, 2017). The GoI infused total capital of Rs. 1,692 crore into the bank during FY2016 and FY2017 and an additional Rs. 4,865 crore capital in FY2018 as part of its public sector banks recapitalization programme. The capital infusion in March 2018 has aided Canara Bank in maintaining CET-1 of 9.5% despite steep losses during FY2018. In ICRA's estimates, the bank would need an additional Rs.5,500-6,000 crore equity capital during FY2019 while achieving RWA growth of 5-7% in FY2019. The bank's management has guided a capital raise plans of Rs.4,500 crore in FY2019, which in ICRA's opinion is sufficient for maintaining a comfortable cushion over the regulatory minimum requirement.

Good advance growth and comfortable in meeting priority sector lending targets - ICRA notes that the bank's gross advances grew by 11.6% to 3.8 lakh crore in FY2018, driven by broad-based growth across all segments. The bank is focusing on conserving capital and has accordingly reduced the ratio of risk weighted assets (RWA) to gross advances to 87.7% as on March 31, 2018 from 95.4% as on March 31, 2017. Further, the credit to deposit ratio stood higher at 72.7% as on March 31, 2018 as compared to 69.1% as on March 31, 2017. The bank's share of total priority sector lending advances was also good at 51.7% of its adjusted net bank credit (ANBC) as on March 31, 2018 (against the minimum requirement of 40.0%), with priority advance to agriculture at 22.2% (18.0%) and the weaker section at 12.8% (10.0%). For FY2019, the bank has guided a lower growth in advances of 7-8% given its focus on increasing the share of retail advances. Given its strong branch network and large customer base, ICRA expects the bank to be able to achieve the targeted growth in FY2019.

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 6,204 as on March 31, 2018. Though the bank's CASA has improved to 34.3% as on March 31, 2018, the same remains low compared to the PSB average of 38%. The bank had a good liquidity profile with a liquidity coverage ratio of 115.2% as on December 31, 2017 as against the regulatory requirement of 100%, w.e.f. January 1, 2019.

Credit challenges

Stressed asset quality with continued pressure in the near term – Canara's gross NPAs increased to 11.8% as on March 31, 2018 from 9.6% as on March 31, 2017 on account of significantly high slippages during the year. Fresh slippages during FY2018 was Rs.24,580 crore of which Rs.13,208 was in Q4 FY2018. While normal slippages for Q4 FY2018 were in the range of Rs.2,500 crore, additional slippages during the Q4FY2018 were on account of RBI's revised framework for resolution of stressed assets, divergence in asset classification as audited by RBI and some large slippages. Aided by large write-offs, the bank's gross NPA as on March 31, 2018 increased to Rs.47,468 crore (11.8%) from Rs.34,202 crore (9.6%) as on March 31, 2017. While the provisioning cover improved to 39.9% (58.1% incl technical write-off) as on March 31, 2018 from 36.7% (55.6% incl technical write-off) as on March 31, 2017, it remains lower than other peer public-sector banks resulting in weak solvency levels with Net NPA / Net worth of 98.1%.

The management has guided a reduction in the NPA levels during FY2019 supported by lower slippages, recoveries in stressed assets undergoing resolution and up-gradations. By September 30, 2018, the bank's management expects gross

NPA and net NPA to be 9.5% and 5.5% respectively and further reduce to 9.0% and less than 5% respectively by March 31, 2019.

As on March 31, 2018, the bank's standard restructured advances stood at Rs.3,720 crore (1.1% of standard advances), the standard portion of 5:25 advances amounted to Rs.2,573 crore (0.7% of standard advances), S4A advances of Rs.1,181 crore (0.3% of standard advances) and advances under refinancing scheme classified as standard amounting to Rs.2,016 crore (0.6% of standard advances) which could continue to maintain pressure on asset quality. However, out of the ~Rs.15,300 crore exposure on NCLT accounts, the bank has a good provision cover of 62%; thereby limiting the extent of haircuts upon resolution.

Profitability to remain under pressure because of higher credit cost – While NIMs as % of ATA remained stable at 1.8% during FY2016 and FY2017, it increased to 2.0% during 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, with asset quality indicators remaining weak, the credit provisions (as % of ATA) remained high at 2.5% in FY2018, surpassing core operating profits at 1.3% of ATA thereby resulting in loss before taxes of Rs.6,560.9 crore. The credit provisions stood at Rs.8,762.6 crore (2.5% of ATA) during Q4FY2018 and were driven by incremental provisioning requirements for ageing NPAs and additional provisioning requirement on account of the divergence in asset classification as audited by RBI, revised stressed assets framework and elevated provisioning requirements on accounts referred under insolvency and bankruptcy code (IBC) 2016.

The bank has not availed any of the RBI dispensation for deferment of provisioning of losses on accounts referred under the IBC, mark-to-market losses on the bond portfolio and gratuity liabilities. For FY2019, the bank's management has guided the credit cost to be in the range of 1.25% of net advances (or ~2% of ATA), which will exceed core operating profits (excluding treasury income) and hence the profitability will be driven by divestment of non-core assets and other treasury income, if any. Also, its ability to improve recoveries and control incremental slippages would be crucial to contain the credit cost. Overall ICRA expects, the internal capital generation of the bank to remain weak in FY2019.

Sizeable capital requirement to maintain capital cushion in relation to rating category - The bank's capitalisation profile was moderate with tier-I at 10.3% as on March 31, 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 equity capital requirement in the range of Rs.5,500-6,000 crore to maintain a comfortable cushion over the minimum regulatory requirement – especially considering the pressure on internal capital generation. A part of the equity capital requirement is expected to be met through divestments of non-core assets and the balance through fresh capital raise. The bank also has board approval to raise Rs. 4,500 crore of capital through non-Government sources. The bank's ability to raise the capital in a timely manner would be crucial from rating perspective.

The previous rating rationale is available on the following link: Click here

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

About the bank:

Canara is a large nationalised bank with the GoI owning a majority stake of 72.6% as on March 31, 2018. Headquartered in Bangalore, Canara has a pan-India presence, directly through its network of 6,204 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 March 31, 2018, the bank had 8.3 crore strong clientele accounts.

Key financial indicators

	FY2017	FY2018	Q4 FY2017	Q4 FY2018
Net Interest Income (Rs. crore)	9,872	12,163	2,708	2,988
Profit before Tax (Rs. crore)	1,642	(6,561)	264	(7,310)
Profit after Tax (Rs. crore)	1,122	(4,222)	214	(4,860)
Net Advances (Rs. crore)	3,42,009	381,703	3,42,009	381,703
Total Assets (Rs. crore) (adjusted for revaluation reserve)	5,78,146	610,361	5,78,146	610,361
% CET 1	8.9%	9.5%	8.9%	9.5%
% Tier 1	9.8%	10.3%	9.8%	10.3%
% CRAR	12.9%	12.2%	12.9%	12.2%
% Net Interest Margin / Average Total Assets	1.8%	2.0%	1.9%	2.0%
% Net Profit / Average Total Assets	0.2%	-0.7%	0.2%	-3.2%
% Return on Net Worth	4.1%	-14.5%	3.1%	-67.1%
% Gross NPAs	9.6%	11.8%	9.6%	11.8%
% Net NPAs	6.3%	7.5%	6.3%	7.5%
% Provision Coverage incl Technical Write-offs	55.6%	58.1%	55.6%	58.1%
% Net NPA / Net Worth	76.5%	98.1%	76.5%	98.1%

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 (FY2018)				Chronology of Rating History for the past 3 years			
	Type	Amount rated (Rs. crore)	Amount Outstanding (Rs. crore)	May-18	FY2018 Mar-18	FY2017 Dec-16	FY2016 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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